S. HRG. 110–735

Senate Hearings

Before the Committee on Appropriations

Financial Services and General Government Appropriations

Fiscal Year 2009

110*th* CONGRESS, SECOND SESSION

H.R. 7323/S. 3260

COMMODITY FUTURES TRADING COMMISSION
CONSUMER PRODUCT SAFETY COMMISSION
DEPARTMENT OF THE TREASURY
DISTRICT OF COLUMBIA: COURT SERVICES AND OFFENDER SUPERVISION AGENCY
FEDERAL TRADE COMMISSION
OFFICE OF MANAGEMENT AND BUDGET
SECURITIES AND EXCHANGE COMMISSION
SELECTIVE SERVICE SYSTEM
THE JUDICIARY

Financial Services and General Government Appropriations, 2009 (H.R. 7323/S. 3260)

S. HRG. 110–735

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

H.R. 7323/S. 3260

AN ACT MAKING APPROPRIATIONS FOR FINANCIAL SERVICES AND GENERAL GOVERNMENT FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 2009, AND FOR OTHER PURPOSES

Commodity Futures Trading Commission
Consumer Product Safety Commission
Department of the Treasury
District of Columbia: Court Services and Offender Supervision Agency
Federal Trade Commission
Office of Management and Budget
Securities and Exchange Commission
Selective Service System
The Judiciary

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FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

WEDNESDAY, MARCH 5, 2008

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3 p.m., in room SD–138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Brownback, and Allard.

DEPARTMENT OF THE TREASURY

STATEMENT OF HON. HENRY M. PAULSON, JR., SECRETARY OF THE TREASURY

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon, and I'm pleased to convene a series of hearings to examine fiscal year 2009 funding requests. Today we launch our lineup with the Department of the Treasury.

Welcome, Secretary Henry Paulson, to the hearing room, along with any associates who would like to join in your testimony.

I welcome my colleagues who will join me shortly, and others who may arrive. Although, this is a budget hearing for the Treasury, we've scheduled a separate hearing next month to devote particular attention to the Internal Revenue Service (IRS), the Treasury's largest bureau. We'll defer the bulk of our questions relating to the IRS until that hearing.

The non-IRS portion of the Department's budget constitutes over $1.1 billion, supporting many critical activities in the central programs we'll concentrate on today.

The Department plays a pivotal role in the global economy, and as an ambassador for the Nation's economic and financial institutions. In fulfilling the mission, Treasury promotes economic prosperity, and ensures the financial security of our Nation.

Treasury also administers the world's largest collection system, over $2 trillion a year. In addition, Treasury supports financial institutions in generating community development, and leads Government efforts in the area of financial intelligence.

I'm pleased that for fiscal year 2008, we were able to provide additional funds for the Department to address several important needs. The funds will further support the Department's efforts to combat terrorism, through implementing economic sanctions, and gathering and analyzing financial intelligence.

For fiscal year 2009, the budget request for Treasury is $12.47 billion, an increase of $461.6 million, or 3.8 percent. Excluding IRS, the request for the remainder is $1.11 billion. This represents a net decrease of $7.5 million over fiscal year 2008, overall reduction of less than 1 percent. This would appear to be a very restrained budget for the non-IRS portion of the Department, however, the top line includes a 70 percent decrease from fiscal year 2008 funding level for the Community Development Financial Institutions Fund (CDFI), commonly known as CDFI.

Holding CDFI funding at the fiscal year 2008 level, the fiscal year 2009 President's budget reflect a $57.9 million, or 5.2 percent increase for the non-IRS portion of the Treasury Department. I'm concerned about this proposed cut in CDFI, which we will discuss later, because I believe that the infusion of capital to these institutions can help many distressed communities, and low-income individuals, who are facing the economic downturn, with more severity than most.

I think it's clear that adequate funding for CDFI is critically important.

For the Office of Terrorism and Financial Intelligence (TFI), including Financial Crimes Enforcement Network, known as FinCEN, the budget requests $153 million for fiscal year 2009, compared to $142.6 million last year, an increase of over $10 million. I'm pleased to see Treasury continues to emphasize strategies to counterterrorist financing and money laundering.

Beyond the Treasury Department, I also want to talk for a few minutes with the Secretary about broader economic issues. I know you've faced that already once today, so you've undoubtedly been prepared for this by my colleagues in the House.

I appreciate your insights on the current housing crisis and the state of the economy, and we'll have a few questions along those lines. I look forward to discussing them with you.

At this point, since Senator Brownback has not arrived, I would like to turn the floor over to the Secretary, and Mr. Secretary, you may proceed with your remarks.

Secretary PAULSON. Thank you, Senator Durbin—there we go.

Senator DURBIN. Thank you.

Secretary PAULSON. That's always the most difficult part of the hearings, turning on the microphone.

But, thank you very much for your remarks, and for your support of the Treasury. I very much appreciate the opportunity to discuss the Treasury Department's proposed fiscal year 2009 budget.

Our budget request reflects the Department's continued commitment to promoting a healthy U.S. economy, fiscal discipline, and national security. The Department has broad responsibility in Federal cash management, tax administration, and plays an integral role in combating terrorism, terrorist financing, and advocating the integrity of the U.S. and global financial systems.

Our spending priorities for the 2009 fiscal year fall into six main categories. I'll briefly describe their priorities and then take your questions.

Treasury has an important role to play as a steward of the U.S. economy, and provides—and our offices provide technical analysis,

economic forecasting and policy guidance on issues ranging from Federal financing, to domestic and global financial systems.

Those functions are especially critical now, as the U.S. economy—through a combination of a significant housing correction, high energy prices, and capital market turmoil—has slowed appreciably.

Our long-term economic fundamentals are solid, and I believe our economy will continue to grow this year, although not nearly as rapidly as in recent years.

In response to economic signals early this year, the administration and Congress worked together to quickly pass, on a bipartisan basis, the Economic Stimulus Act of 2008, and I would like to thank this subcommittee for approving funds for the IRS and the Financial Management Service (FMS), to administer the stimulus check rebate program under the act, so thank you for that.

As you know, the stimulus payments to households, and the incentives to businesses in the act, together are estimated to lead to the creation of 500,000 jobs by year-end. This will provide timely and effective support for families in our economy, and it wouldn't be possible without your leadership.

Treasury's Office of Terrorism and Financial Intelligence (TFI) uses financial intelligence, sanctions, and regulatory authorities, to track and combat threats to our security, and safeguard the U.S. financial system from abuse by terrorists, proliferators of weapons of mass destruction, and other illicit actors.

To continue to build on our efforts to combat these threats, we are requesting an $11 million increase for TFI, including $5.5 million for the Financial Crimes Enforcement Network, to ensure effective management of the Bank Secrecy Act.

The budget request emphasizes infrastructure and technology investments to modernize business processes and improve efficiency throughout the Treasury Department. We will continue to make information technology management a priority, and have taken several significant steps to strengthen our systems and oversight.

Treasury is committed to managing the Nation's finances effectively, ensuring the most efficient use of taxpayer dollars in collecting the revenue due to the Federal Government. The IRS, of course, plays an integral role in all of this, the budget requests a 4.3 percent increase in IRS funding to expand IRS enforcement activities, improve compliance, reduce the tax gap, and continue improvements in taxpayer service.

In addition, we are asking your colleagues on the State, Foreign Operations Subcommittee to support funding both in multilateral development banks—noticeably, new replenishments for the World Bank's International Development Association (IDA), and the African Development Fund, and have forwarded a $400 million request for the first installment of a $2 billion clean technology fund that—with additional funding from other donors around the world, will help finance clean energy projects in the developing world, and make strides toward addressing global climate change.

Overall, the budget request reflects a prudent and forward-leaning approach to fulfilling the Treasury Department's core responsibilities to support our economy, managing the Government's finances, and ensuring financial system security.

PREPARED STATEMENT

I thank you for your past support and consideration of our work, and I look forward to working with you during your deliberations.

Thank you, and I welcome your questions.

[The statement follows:]

PREPARED STATEMENT OF HENRY M. PAULSON, JR.

Chairman Durbin, Senator Brownback, Members of the Committee: Thank you for the opportunity to discuss the Treasury Department's proposed fiscal year 2009 budget. Our budget request reflects the Department's continued commitment to promoting a healthy U.S. economy, fiscal discipline and national security. The Department has broad responsibility in federal cash management, tax administration and plays an integral role in combating terrorist financing and advocating the integrity of the U.S. and global financial systems.

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U.S. ECONOMIC STEWARD

Treasury has an important role to play as steward of the U.S. economy, and our offices provide technical analysis, economic forecasting and policy guidance on issues ranging from federal financing to domestic and global financial systems.

Those functions are especially critical now as the U.S. economy, through a combination of a significant housing correction, high energy prices and capital market turmoil has slowed appreciably. Our long term economic fundamentals are solid, and I believe our economy will continue to grow this year, although not as rapidly as in recent years.

In response to economic signals, early this year the Administration and the Congress worked together to quickly pass, on a bipartisan basis, the Economic Stimulus Act of 2008. And I would like to thank this subcommittee for approving funds for the IRS and the FMS to administer the stimulus check rebate program under that Act.

As you know, the stimulus payments to households and the incentives to businesses in the Act, together, are estimated to lead to the creation of half a million jobs by year-end. This will provide timely and effective support for families and our economy, and it wouldn't be possible without your leadership.

STRENGTHENING NATIONAL SECURITY

Treasury's Office of Terrorism and Financial Intelligence (TFI) uses financial intelligence, sanctions, and regulatory authorities to track and combat threats to our security and safeguard the U.S. financial system from abuse by terrorists, proliferators of weapons of mass destruction and other illicit actors.

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Efficient Management of the Treasury Department

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FISCAL DISCIPLINE

Treasury is committed to managing the nation's finances effectively, ensuring the most efficient use of taxpayer dollars and collecting the revenue due to the federal government.

Enforcing the Nation's Tax Laws Fairly and Efficiently

The Internal Revenue Service, of course, plays an integral role in this. The budget requests a 4.3 percent increase in IRS funding.

As in the past three budget requests, we are proposing to increase IRS enforcement funding as a Budget Enforcement Act program integrity cap adjustment. IRS enforcement efforts have yielded record revenue collections. With the requested funding, the IRS will collect an estimated $55 billion in direct enforcement revenue in 2009.

The budget also includes a number of legislative proposals intended to target the tax gap and improve tax compliance, with an appropriate balance between enforcement and taxpayer service. These proposals are estimated to generate $36 billion over the next ten years.

INTERNATIONAL PROGRAMS

We will continue to focus efforts on supporting a stable and growing global economy, through on-going dialogue and initiatives with developing economies throughout Asia, Latin America and Africa.

In addition we are asking your colleagues on the Foreign Operations Subcommittee to support key objectives of the President's international assistance agenda. This includes funding for the multilateral development banks—notably new replenishments for the World Bank's International Development Association (IDA) and the African Development Fund.

Also included as a Foreign Operations priority is $400 million request for the first installment of a $2 billion clean technology fund that, with additional funding from the United Kingdom, Japan and other donors, will help finance clean energy projects in the developing world and make strides towards addressing global climate change.

CONCLUSION

Overall, the budget request reflects a prudent and forward-leaning approach to fulfilling the Treasury Department's core responsibilities to support our economy, managing the government's finances and ensuring financial system security. I thank you for your past support and consideration of our work, and look forward to working with you during your deliberations.

Thank you and I welcome your questions.

Senator DURBIN. Thanks, Mr. Secretary, and I welcome my ranking member, Senator Brownback, of Kansas.

If you have an opening statement, I'll defer to you at this point.

Senator BROWNBACK. I'll just make some of those comments during my questions, I think that would probably be the best, prudent way.

If I could, Mr. Chairman, I'd ask if I could put my full statement in the record, right now.

Senator DURBIN. Without objection.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Good afternoon. At this first hearing of our subcommittee, I want to thank you, Chairman Durbin, for your leadership. I look forward to working together with you during this coming year as we make funding decisions and provide oversight to the various agencies within this subcommittee's jurisdiction.

Secretary Paulson, thank you for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2009 budget request and the key efforts that your department will be undertaking this year. You have a crucial role in overseeing our financial systems and in promoting our participation in the international economy so I am interested in hearing your thoughts on the domestic and global economic situation.

Looking at the President's budget, I am pleased that it assumes the continuation of the President's tax cuts, which are key to preventing recession and allowing our economy to rebound from the sub-prime mortgage crisis. I am encouraged that the President's budget projects a balanced budget by 2012.

Mr. Secretary, regarding the economic stimulus package, I support the tax rebates to families and the expensing and depreciation changes to assist businesses. But I believe that we must look down the road at other ways to stave off recession, such as enacting incentives for U.S. companies to bring money back to this country from abroad. This would allow multi-national corporations to bring funds into the United States at a reduced tax rate for a period of time. I believe that we must continue to be proactive to keep our economy healthy. The most effective way to do this is to lower taxes so that consumers and businesses have more of their own money to spend and invest.

Mr. Secretary, the lion's share of your budget—approximately 90 percent—is for the Internal Revenue Service. I understand that you are seeking additional resources to close the so-called "tax gap." Certainly, we must ensure that taxes which are owed are collected. However, I remain concerned that our tax system is overly complex, complicated, and burdensome. Americans spend roughly $157 billion each year in tax preparation to ensure they do not run afoul of the IRS. The system is desperately in need of reform. One reason we have a "tax gap" may be that our tax system is so complex that taxpayers cannot figure out what they owe.

Mr. Secretary, I want to commend your Department for its efforts to combat terrorism. Your "Office of Terrorism and Financial Intelligence" is working hard to safeguard the financial system against illicit activities and combating rogue nations, terrorist facilitators, money launderers, drug kingpins, and other national security threats. This is important work and I am supportive of your efforts in this area.

I know that the Treasury Department is aggressively blocking U.S. commercial bank transactions connected to the government of Sudan, including those involving oil revenues. I am pleased that you are taking these actions. Last year, we passed legislation and the President signed into law the authority for your Department to levy greater criminal and civil penalties for those who violate these sanctions. I hope this new authority has acted as a strong deterrent for bad behavior.

Mr. Secretary, I am deeply concerned that American consumers are unwittingly purchasing products that have been manufactured with natural resources extracted by enslaved and abused children in countries where the profits are then used to support murdering and raping rebels. For example, I believe that our demand for coltan—which is an essential mineral needed for the manufacture of cell phones, TVs, and computers—has helped to fuel the conflict in the Congo. We need to be vigilant to ensure that American manufacturers are not supporting the conflict in the Congo by purchasing coltan. I would like you to work with us and perhaps the SEC to prevent American companies from purchasing coltan that has been mined by children and whose profits are supporting killings in the Congo. Congo's "conflict coltan" has created a vast and grave humanitarian crisis where 5.4 million people have died since 1998 directly and indirectly from the conflict and where 1,500 people continue to die each and every day.

We cannot sit idly by while others suffer. We need to be responsible as a nation and as consumers. We must hold our suppliers accountable. I plan to introduce legislation to stop the exploitation of coltan, particularly in eastern Congo. I am working with leaders of non-governmental organizations who understand the situation as I write this bill.

Mr. Secretary, I would like to hear what your Department is doing to support a stable and growing global economy through initiatives with developing economies throughout the rest of Africa and Latin America. I would like to hear how you can help ensure that we are not complicit in illegal activities in Congo and the rest of the world.

So Mr. Secretary, I look forward to hearing your testimony this afternoon.

Thank you, Mr. Chairman.

HOPE NOW ALLIANCE

Senator DURBIN. Mr. Secretary, the Treasury Department reported Monday that loan modifications under Hope Now helped 45,000 borrowers in January. But that number, as I understand it, includes all modifications of any sort, including those that only temporarily delayed foreclosure, rather than only counting mortgage changes that would allow families to stay in their homes for a longer period of time.

Isn't it true that Hope Now numbers you're citing include all mortgage changes of any sort?

Secretary PAULSON. Yes sir, very much.

And let me say that with Hope Now, the objective is—and the numbers you were citing have to do with subprime mortgage holders who were facing resets. And a major objective there is to help those homeowners who were facing resets they couldn't afford, and help them stay in their homes, and modifications to change the terms and to change, you know, the terms on a mortgage that lets someone stay in their home, is what we're about doing.

The other thing I would point out is that we're very fortunate in the—to the extent that the rate cuts that the Federal Reserve had made, made the impact of the some of the resets much less severe. And prior to the rate cuts, some of the initial resets were going to take the rates from 8.5 percent to 10.8 percent. After the rate cuts, they, you know, the impact was more like 8.5 to 9 percent. So, again, we received help there. And I certainly don't discount modifications that mortgage servicers made to let people remain in their homes.

Senator DURBIN. Are you satisfied that the financial institutions across America have responded voluntarily to the administration's request, in an adequate way, to deal with the current mortgage foreclosure crisis?

Secretary PAULSON. The way I would answer that question is I'm gratified by the progress that's been made, to date. And again, there's been some criticism, but in terms of an initiative that's up and going, I happen to believe it stacks up well, relative to anything else I see out there.

So, I would start off by saying that there's been 1 million people helped, to date, and I don't discount that at all, I think it's significant.

Now, the objective here—and I want to put this in perspective—that what we have is an industrywide effort in looking at subprime mortgages, where we have servicers covering 90 percent of the market. There are varying degrees of aggressiveness and sophistication in that group. And there are some firms in that group that didn't even need Hope Now to be doing the right things. And they've been out and they've been leading, and I thank them.

There are other servicers in that group that has less sophistication, were less prepared, we had significant obstacles—legal obstacles, accounting obstacles—we had the Securities and Exchange Commission (SEC) sign off on some accounting guidance on January 8, and technological issues.

So, the way I look at it right now is, we have some leaders, we have some followers, we have now—the followers fully implementing the protocol, and we have them doing that ahead of the biggest period of recess——

Senator DURBIN. Let me try to narrow it down, because I want to get to the point of understanding this. When you talked about 1 million borrowers being helped——

Secretary PAULSON. Yes.

Senator DURBIN. And that you're satisfied with some responses—I'm trying to put the response level, or the response so far, I should say, in the context of the challenge that we face.

Secretary PAULSON. Right.

Senator DURBIN. And I have heard that some 2.2 million—at least that's a common figure—mortgage holders in America—subprime mortgage holders—face the probability, possibility of foreclosure.

Secretary PAULSON. Right.

SUBPRIME BORROWERS

Senator DURBIN. I don't know if that's an accepted figure or an accepted estimate, but I've heard it repeatedly.

So, what do you think, what would—how would you describe, in percentage terms——

Secretary PAULSON. Right.

Senator DURBIN. The number of those vulnerable homeowners who have been helped, to date——

Secretary PAULSON. Right.

Senator DURBIN. By the administration's programs?

Secretary PAULSON. Well, let me say—first of all, let me deal with numbers. And if you give me a minute or two on this, we'll go through it.

That in a average, good year, you know, if we looked at 2002 through 2005, there are 650,000 foreclosures. Last year, estimates are there will be about 1.5 million. Some people are projecting 2 million foreclosures this year.

Now, I think, you sir, Mr. Chairman, are right to focus on subprime because if we look at the third quarter of last year, we had roughly 13 percent of these 55 million mortgages are subprime mortgage—they were——

Senator DURBIN. The 55 million mortgages?

Secretary PAULSON [continuing]. 55 million mortgages, 13 percent were subprime.

Senator DURBIN. That's of all the mortgages, you said, universal mortgages, 55 million?

Secretary PAULSON. All the mortgages, yes. And of that subprime universe, of that 13 percent, 50 percent of those were where we had foreclosures. And if you even look at a smaller sample, 6.5 percent were adjustable rate subprime mortgages, and they had 50 percent of the foreclosures.

And we had a—and on top of that—the 18 percent, if you take a look at sort of the—the period when there were the worst underwriting practices, which was 2006, and these so-called "2–28" mortgages, you know, teaser rate for the first 2 years, and then resets—that 18 percent of that pool foreclosed 6 months ahead of even the first reset.

So, again, as I look as the objective—and so, I think what's important, that we talk about what's a reasonable objective, and to me the reasonable objective is that every homeowner who is in a subprime mortgage and is able to afford the initial rates—because if they can't even afford the initial rates, I think there's a different problem we need to deal with—every homeowner that's in a subprime mortgage and is able to afford the initial rates, and can't afford the step-up rate, there should be a solution that keeps them out of foreclosure, if they are willing to talk to someone about it, and engage to talk about solutions.

So, a major issue we continue to have—and we're making progress—is that before Hope Now, that roughly 2 to 3 percent of those getting letters from servicers responded. Half of those going into foreclosure ever talked to anyone. Now the response rate is close to 20 percent—that still means 80 percent aren't having conversations.

Now, it's very hard for the Government or anyone, to help someone who won't try to help themselves, won't respond, won't engage in a conversation. There's also some people out there, where there's a different issue.

Just to step back, and the other issue that's out there, and you hear a lot of conversation about, is the put-out numbers, the 8.8 million homeowners that have mortgages that—where they have zero equity or negative equity in their home. Now, as you look at that universe, as I look at it, if you're a mortgage holder, even if you have negative equity in your home, if you can afford to make your mortgage payment, then I believe you've got an obligation to make the mortgage payment and you don't walk away—you're a speculator if you walk away because you happen to think your home is under water and the—your mortgage is under water. And I think most homeowners look at it this way—I think most homeowners, 93 percent of the homeowners are making their payment every month, you know, even if it's difficult for them to do so—only 2 percent are in foreclosure.

SPECULATORS

So, I do believe—but there are some, some of these, and they're doing terrible practices. Last year, even last year after all of this, 30 percent of the mortgages that remain in this country, there was almost no down payment or no down payment on a mortgage. And so, there are certain people that—sometimes they are second homes, they're speculators, they took out a mortgage, if the home value doesn't go up, they're walking away from that.

That's not the focus. The focus of our program is you've got to want to stay in your home, and respond to someone, and have the capability to do that. And I think on that—and just to finish up, Mr. Chairman—on that, we're continuing to make a very big effort, and I think the industry is, and we're going to monitor that very carefully.

Senator DURBIN. I've gone way over my time, and I want to give Senator Brownback his. But I do—I do want to go back to my question.

Secretary PAULSON. Right.

LOAN WORK OUTS

Senator DURBIN. You've really described the battleground, and the universe, but I want to zero in—how many of these have we helped? If, in fact, there are 13 percent of the 55 million that are subprime, that calculates out to about 7 million—if half of them are facing foreclosure, that's 3.5 million—how many have been reached by Hope Now, and this administration's efforts?

Secretary PAULSON. I would say, to date, okay, Hope Now, since the beginning there have been 1 million homeowners that have engaged in some form of modification or work out, okay? So, there have been 1 million people that have been helped.

But what we're not picking up in our numbers are the refinancings. So, even when you—the number you cited, I looked very carefully at that number, and there were 45,000 modifications, there were 167,000 work outs, both work outs and modifications went up faster than foreclosure starts—which was a positive. But we don't know the number of refinancings. And it's been hard, and there are a lot of refinancings. And so we will do everything we can to measure the numbers that have been helped.

The other thing I'm really focused on is, you can't help people that aren't going to help themselves, or reach out. The standard I really want to set is that if there's a homeowner, and has been able to make the reset, be able to make the initial payment, and they said, "I reached out and I talked to my servicer, and I'm still put into foreclosure," I want to know about that, because again, I want to follow-up. I mean, that's, to me, another—and we're going to work to get the numbers to help answer more and more of your question.

Senator DURBIN. I have some more questions, but I want to defer to my colleague, here.

Senator Brownback.

Senator BROWNBACK. Thanks, Mr. Chairman.

Secretary, thanks for being here. And also, just at the outset, I wanted to thank you for your years of expertise that you bring into the Government. I think particularly at this time with the economic problems we're facing, it's great to have somebody with your background and expertise, and I appreciate it.

Now, I'm going to yell at you, but I first want to tell you how appreciative I am, of you being in Government with this, because I think it does bring a stature that's needed, and it's very helpful to have.

I want to talk about two things—the economy, and terrorist financing. And I appreciate your describing the universe of the home situation, I wanted to describe a philosophy and then ask you questions on how to implement that.

I've been through a similar crisis in the past, my guess is you've also seen a couple of things like this, and so you bring a philosophy that's based on your experience, as well.

I went through the farm crisis of the 1980s, I was a lawyer in an undistinguished practice in the Midwest, and then went on to be agriculture secretary in the State. One of the things I saw in that early 1980s farm crisis—this would have been a Dick statement, Bigway, as well—is we took a crisis and we made it a huge—we took a problem and we made it a crisis. And we did that through trying to get too much done too fast.

There was land that went on the market at a cheap rate, and then—I was representing some farmers and some banks. The regulators came out and told the banks, "Clean up your loans," the banks went out and started suing a bunch of farmers to get their land, so we dropped a whole bunch of land on the market, a whole bunch of equipment, everybody's prices fell a huge amount, and it just exacerbated the problem—we tried to do too much, too fast, and we made it really bad. It was bad.

So, I take that experience and I say that the thing we need to do now, because we've got a real problem here, is we've got to string this out, over a period of time, and not try to see too much housing stock get on the market too fast. Because if you get too much out there, you further plummet, and you get a whole bunch more people that are in trouble.

So, if that's the correct philosophy, we need to meter this out over a period of time. We've got a problem, we had excess capital, or problems coming in, and bad loans taking place, and sharks out there, and we've got to work our way through this.

Is the way to do that not just what the administration is proposing, but also tax credits for purchasing housing or even distressed housing? Or, some people are proposing changes in the bankruptcy code, to provide for a cram-down feature on housing? If you agree with the philosophy, I would like for you to say which actions by Congress you think would be the appropriate ones to prevent this problem from making an even worse impact on the overall economy.

CAPITAL MARKETS

Secretary PAULSON. Right, Senator, I assume since there's just the two of you, I can take a little bit longer time, since I took a lot of time on the chairman's question.

Senator BROWNBACK. Fine.

Secretary PAULSON. Because it's a very good question and I think it deserves a thoughtful answer, and I've thought a lot about it.

The, first of all, I've said for some time, that as we look at this crisis, there's two focuses. First and foremost is getting through this period with as little impact—negative impact—as possible on the real economy, and so second, is what's the policy response to reduce the likelihood of going through this period again, something like this? And so we don't want to do something up front that's going to compound the problem in the short term, or to make it worse in the longer term.

Now, there are a number of—even before you get to the housing, that is why I have been, when we look at what's going on with the capital markets turmoil right now, that I have been so focused on having all of our financial institutions, including the GSEs, raise capital that they need, so that they can be active in, you know, in the market—lending, keeping up their normal economic activities, as opposed to shrinking their balance sheet.

Now, in looking at housing as I've looked at this, and I've looked at a whole lot of things, first I focused on efforts that would avoid what I would call a market failure. And the level of adjustable rate mortgage resets that were coming is such a wave that it wouldn't allow the private sector to react the way they normally would react, which would be to have the investor have time to strike a deal with each individual mortgage holder, and work something out that was in both of their best interest, because foreclosures are costly. And so that's why this ASF protocol, and working the fast-track modifications, to avoid avoidable foreclosures.

The other big effort we still have—we have a number of things that have been done, are when you look at Fannie Mae and Freddie Mac, that we have them today to go back far enough in our history, we didn't, and they can play a constructive, counter-cyclical role. And they have been, but to continue to do so, they're going to have to raise more capital, and be very active there.

Senator BROWNBACK. What about tax credits and bankruptcy reform?

BANKRUPTCY

Secretary PAULSON. Oh, yeah, I would say this now, let me get at both of those. In terms of bankruptcy reform, I've had some very good conversations with your chairman, and he and I have a very

similar objective. We approach this differently, and there's two reasons why I don't like the bankruptcy reform. First, as a matter of property rights and contract, I don't like the idea of retroactively changing contracts, and I'm concerned with what it might do to financing availability going forward.

But even more importantly in working through this, I am emphasizing a program which says, if you're a homeowner, and you want to stay in your home, and you can afford to stay in your home—raise your hand. Call, reach out to someone. And it's a lot quicker than slowing it down, and bogging down our courts.

Senator BROWNBACK. What about the tax credit ground?

TAX CREDITS

Secretary PAULSON. Yeah, I think the, you know, the tax credit, I understand the concept very well, because we're looking at it—the overhang, and the inventory of unsold homes. I think that what you're apt to get with that is something that's going to prolong the issue. And so, net-net—although I look at it as a creative idea, there have been some creative ideas—we are much more focused right now, and let's get the GSE reform, get the Federal Housing Administration (FHA) modernization done, get the tax-exempt financing done, and so we're not there on the tax credit. But, again, I understand what people are seeking to get at with that proposal.

CONFLICT MINERALS

Senator BROWNBACK. If I could just ask one more question in the length of time we have. I've handed you a proposal, this is on financing—terrorist financing, and also conflict commodities financing, I think it's a topic you—the administration has done a pretty good job of trying to get at—terrorist financing.

I want to put another issue in your portfolio, and it's conflict commodities in Africa, particularly from the Sudan and Congo.

Secretary PAULSON. Yes.

Senator BROWNBACK. And that we really start targeting these commodities coming out of conflicts so as to prevent further exacerbation of the conflict.

Secretary PAULSON. Yes.

Senator BROWNBACK. Senator Durbin and I went to Congo together, I've even got a picture of one of the coltan coming out of Congo, financing it, now tin is being used—these are kind of Mom and Pop mining operations.

Secretary PAULSON. Yes.

Senator BROWNBACK. This is kind of how they mine coltan that's in your cell phone, or even tin out of Congo, this picture is taken out of Congo. No other group—they've got a proposal out of a draft piece of legislation saying that we won't purchase commodities from conflict zones, where that money is used to finance rebel groups.

I would urge you to look at it, because I think this going to be one of the keys for us to try to stabilize Africa.

Secretary PAULSON. Yes.

Senator BROWNBACK. We need to keep the money from going to these rebel groups, particularly like in the eastern Congo, it's a classic place. I think it's also what we need to look at in the Sudan.

Secretary PAULSON. Yes.

Senator BROWNBACK. There you've got a government that's being primarily financed by oil and I think we need to be very aggressive on this in looking at it.

And I would draw to your attention to one other thing, that we have done, Senator Durbin and a number of others worked on the Sudan Divestment Act that passed. I'd like to see us do a similar one on Iran, as a way to divest and get money out of the financing of the conflicts.

I draw that one more to your attention than for a response, unless you give me a positive response, you don't need to respond at all.

Secretary PAULSON. How could I not be positive? Because this is a real problem, and your leadership and the chairman's leadership are very much appreciated on this. And I will pass on the comments to Secretary Rice and others at the State Department, because I think this is something that I know is an important issue.

Senator BROWNBACK. Thank you.

Senator DURBIN. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman, thank you for holding the hearing to examine the budget request for the Treasury Department.

And it's a pleasure to be here, to be able to welcome you, Secretary Paulson. We have an opportunity to see one another quite frequently——

Secretary PAULSON. Yes.

COSTS OF COINS

Senator ALLARD. And so I do appreciate the job that you're doing and I apologize for being—not being able to be here to hear your testimony this afternoon, we started markup on the budget—we started debating the budget, and so, I'm on the Budget Committee, so it's important that I at least be there for the opening part of the Budget Committee debate.

I did want to stop by briefly to raise one issue which has important appropriations implications, and I appreciate my colleagues accommodating my schedule on this.

Last week on a radio program, you'd advocated for the elimination of the penny, but added that you didn't think it was politically doable.

Secretary PAULSON. I didn't——

Senator ALLARD. If my information is correct.

Secretary PAULSON. No, I did not advocate it. I've got no intent, no plans to advocate it. What we're advocating, though, very strongly, for is we have legislation that would change the content of the——

Senator ALLARD. Well, that's what I'm getting at.

Secretary PAULSON. The penny and the nickel.

Senator ALLARD. Yeah.

Secretary PAULSON. Which would save the American taxpayer a good bit of money.

Senator ALLARD. Okay. This was an Associated Press story. They must have got that wrong in the story.

Secretary PAULSON. Yeah, I said—what I had—we have no intent or plans to——

Senator ALLARD. Well, we can still move forward with my question.

Secretary PAULSON. Right.

Senator ALLARD. Because I've introduced legislation, I believe we've got bipartisan support on this, S. 1968, which gives the flexibility to the Treasury Department to manage the content of the coin.

Secretary PAULSON. Right.

Senator ALLARD. Metal content. So, my question is, is—how much do you think this could save, as far as the Treasury Department is concerned, and how urgent do you think it is that we get this changed, to give you the flexibility with the changing metal market. You know, gold right now is at a historic high, I think, and a lot of our metals are falling right in behind that.

Secretary PAULSON. Yeah, it is, you know, we're losing money for every penny we mint and——

Senator ALLARD. Even a nickel, too, right?

Secretary PAULSON. I don't have the number offhand—oh, the nickel's even more. It's—I think the nickel—directionally right, if it's, it costs 7.7 cents or something, to make a nickel or 1.4 cents to make a penny, and I'll get you the numbers.

[The information follows:]

COST OF PENNIES AND NICKELS

Using current metal prices (February 2008), production costs this year for the Mint will be more than 1.3 cents per penny and 7.7 cents per nickel.

Secretary PAULSON. But, when I looked at it over the period of time, we're talking about hundreds of millions of dollars.

But, whatever the number is, there's no reason to be losing money in a needless way. And so we just need to change the metal content of those coins.

METAL CONTENT OF COINS

Senator ALLARD. Well, you know, and I sympathize with—given you and the various agencies that you work with, the flexibility to change that metal content. Because, you know, all of these metals—they change in value from year to year, and I don't think the action of the Congress can keep up with it, and if we can do this in a way that saves taxpayer dollars——

Secretary PAULSON. Right.

Senator ALLARD [continuing]. I think we ought to do it. And the sooner the better. And so anything you can do on that to help us get the message out, we'd appreciate it. I do think it's a very commonsense kind of piece of legislation, and something that I think we need to do.

Secretary PAULSON. It is. It is, very much.

Senator ALLARD. So, anything you can do on that, we'd appreciate it.

And you know, I—I guess the question is, are there metals that we would use that—we potentially could use—that we're not using now?

Secretary PAULSON. Yes.

Senator ALLARD. Yes.

Secretary PAULSON. They are—they're composites, and there's been a lot of work done on this.

Senator ALLARD. Is that right?

Secretary PAULSON. And I'd be very happy to send some people up to give you all the details on it, because there's been a lot of good work done on this by the Mint.

Senator ALLARD. I would appreciate us being briefed on that, if you would, please. And maybe other members of the subcommittee would be interested in that.

Secretary PAULSON. Go through the whole economic analysis.

Senator ALLARD. Okay, well, very good, well I'd like to follow-up on that a little bit, and maybe we can all get that information, get briefed together, or something. I don't know if we need to have a formal hearing on it, Mr. Chairman, but if you wanted to include it or something for the members of the subcommittee, we could do that. But, I'm particularly interested in it, and would like to have that information.

Thank you.

Senator DURBIN. I thank the Senator from Colorado, and just for the record the Lincoln penny was initiated 100 years ago, on the 100th anniversary of Lincoln's birth. And the bicentennial of that birth, next year, will result in four new backs for the penny to show different aspects of Lincoln's life. And the metal content is secondary to the people of Illinois, as long as Lincoln's on the penny.

Secretary PAULSON. But, we can do them both, right?

Senator DURBIN. Right, no objection.

Secretary PAULSON. We can do them both, and we celebrate it.

Senator DURBIN. Yes.

BANKRUPTCY

Mr. Secretary, Federal Reserve Chairman Bernanke recently said, relative to the foreclosure crisis, "Principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquencies and foreclosure." And he continued, "When the mortgage is under water, a reduction in principal may increase the expected payoff to the bank by reducing the risk of default and foreclosure."

I want to say a word about the bankruptcy provision which you've alluded to, because Senator Brownback will get a chance to consider that measure in a day or two in our Senate Judiciary Committee.

Over the months since we've first initiated the concept, we have changed it dramatically. Originally, we said that there was no equity or justice in allowing a bankruptcy court to modify the terms of a mortgage on a vacation condo, a farm or a ranch, but to prohibit, by law, any modification of the terms of a mortgage on a principal residence or a home. And so, initially, we began with the premise, let's treat them all the same, allow the bankruptcy court that option.

But, some have observed that that may have a negative impact, so we have dramatically restricted the bankruptcy reform that I am proposing. First, it's harder to get into bankruptcy court today

than it was 5 years ago. You have chapter 13, which requires certain requirements, income requirements and the like, before you can end up in the bankruptcy court.

Second, we restricted this provision, this change, only to homeowners, so no speculators need apply. You have to actually live in the home we're talking about.

Third, we said only subprime mortgages for those homes.

Fourth, we said that any modification of the terms of the mortgage could not reduce the principal any lower than fair market value to protect—as best we can—the lender who, if they're facing a distress sale, are lucky to see fair market value.

Then we said the interest rate has to be based on the prime rate plus a reasonable premium for risk. And, we added another provision which, I think, is an effort to go an extra mile to win back some support from the banking community, and it did win the support of credit unions. If there is a modification of the principal on a mortgage in a bankruptcy facing foreclosure, and say a house is re-valued from $500,000 to $450,000, and then in subsequent years, increases in value, back up over $450,000—that delta, that change, that improvement—will go to the lender. So, we're trying to protect the lender on the downside fair market value and the upside, in terms of appreciation.

What I'm troubled with is this reference by yourself and bankers to the "sanctity of the contract." I've seen some of these contracts in our home State. There's nothing holy about how these contracts were entered into. Many of them were deception at its worst. People were taken advantage of. Poor people, uneducated people, senior citizens.

And to hold these as "holy instruments" which now must be respected, overlooks the obvious—when we changed the bankruptcy code 5 years ago, we changed the impact of all of the contracts that come in under bankruptcy. The sanctity of the contract was never raised by the banks who wanted to change the bankruptcy code for their advantage.

Now, when they may end up negotiating a contract of mortgage which they've resisted negotiating, they're arguing the sanctity, the "holiness" of the integrity of this contract. And I will tell you, I can give you chapter and verse of some that were as unholy as you can imagine.

Secretary PAULSON. Can I respond to that?

Senator DURBIN. Of course.

Secretary PAULSON. Because there is no way you're ever going to get me defending some of those loans. And I am cheering on our law enforcement agencies, everyone that is going after the fraud.

What I was talking about was taking a bankruptcy statute, that was designed the way it was for a reason. The presumption is the judge is going to—you're not going to be altering the terms of a vacation home or a sailboat, or whatever. You're in bankruptcy, the presumption is, you lose it.

Senator DURBIN. Not in chapter 13.

Secretary PAULSON. It's——

Senator DURBIN. Not in chapter 13.

Secretary PAULSON. But, I'll tell you, it's a much different presumption when you're talking about your home. But again, rather

than—I just make two points, okay? And I'll just make them again, and make them quickly. That, to me when you change a bankruptcy statute and do it retroactively—I recognize you've narrowed it, okay?—to change it retroactively, it's something that gives me pause. And then second, again, that when you look at bogging down the system and dumping this in the courts when I think a simpler, more effective way to deal with it is to have homeowners when there's a problem, go deal with it.

And a large number of foreclosures we're seeing, from everything I can learn, is homeowners not responding.

Senator DURBIN. But, Mr. Secretary, let me tell you, you said that earlier. "If you can make the original payment and can't make the reset, hold up your hand," you said. Well, you've got hundreds of thousands of borrowers across America who are in this predicament, and to say to them, "You should go take care of your problem."

What I'm saying to you is, the response so far, the voluntary response of your administration programs has reached some, but not nearly enough to turn this crisis. The Fed—the Chairman of the Federal Reserve, Mr. Bernanke, is basically said what I am saying. That there comes a moment in time, that if you want to turn this crisis, you have to deal with the reality.

I don't want these people to go to bankruptcy court—if I could just finish—I don't want these people to end up in bankruptcy court. But if the lender understands that there is a possibility of bankruptcy and modification, they are much more likely to renegotiate the terms of the mortgage before bankruptcy. Currently, there is no incentive.

Secretary PAULSON. Listen, I very much appreciate what you're trying to do and your motives, you appreciate mine. As far as I know, Ben Bernanke is not advocating changing the bankruptcy law retroactively. And again, there's a fact, and the fact is that we're making a huge effort. There still are a fair number of people that—a large number of people, a disappointing number of people—aren't responding when they get numerous letters and phone calls and they hear—and all I'm saying is, wouldn't it be easier to—and how do you help someone if they're not going to raise their hand and——

COUNSELING FUNDING

Senator DURBIN. Then let me ask you this question, why did the administration issue a statement saying that they would veto the housing stimulus bill before the Senate last week, and one of the reasons because it would have substantially increased the number of counselors available for those facing foreclosure. If your argument is that enough people aren't seeking help, why did the administration say that that was one of the specific reasons they would veto the housing stimulus bill?

Secretary PAULSON. Well, I missed that part of it, because I will tell you that counseling is vital. And one of the things that the administration has been advocating has been funding for counseling, and funding a counseling partially by the servicers at Hope Now, and the whole effort. And the 888–995–HOPE number is to get people to call and get to counseling.

So, you know, I didn't read that part that you're referring to, but I sure know that the—we've got a similar objective and I appreciate the fact that you've narrowed it appreciably, and again, I'm just giving you my——

Senator DURBIN. Senator Brownback.

LOAN WORK OUTS

Senator BROWNBACK. Thank you, and this is a good discussion, because I remember the same discussion during the farm crisis time period. And, a lot of these loans need to be restructured.

Is it your belief that a number of the loans that people want to restructure are being restructured by financial institutions?

Secretary PAULSON. I sure believe that.

Senator BROWNBACK. Do you have any hard numbers that you've been able to track or to look at?

Secretary PAULSON. What we've got—here's some hard numbers I've got. Some are encouraging and some are discouraging.

That, before this effort, 2 to 3 percent of the people were responding to servicers, when they went to homeowners that were facing resets or delinquent. Now, 20 percent are responding, okay? So, that's a positive.

We have a hard number that since the beginning of putting this together, that there have been 1 million homeowners who have been helped—either, you know, through a, through a work out of some sort.

We have hard numbers that this last—the last month, that I was encouraged to see modifications and work outs growing faster than foreclosure starts. But, I don't have numbers on refinancings.

Part of the problem we have, Senator, is that—as I said earlier, there are really—and the chairman made that point—there were just egregious, some of the lending contracts and some of the way people were put in these loans, and there—but there were 18 percent of the 2006 adjustable rate subprime mortgage holders defaulted 6 months before the first reset. They couldn't afford the initial payment.

And so, there are, regrettably, going to be some people that are going to return to becoming renters. But, again, I'm going to work hard to make the Hope Now Alliance work, and work better, we're going to work as hard as we know how to get the data out there and to track it, and I've got to tell you, if something isn't working the way it needs to work, then we're open—and I'm sure open—to making modifications in the way we approach things. We just have a——

Senator BROWNBACK. Secretary, if I could, and I just wanted to interject, and I appreciate you going through this—my raw point on this would be that I really hope that the financial institutions and the administration can make the work outs work.

Secretary PAULSON. Yes.

Senator BROWNBACK. Because if it looks like things aren't working or that the financial industry says, "Look, we're just going to dig in and start fighting on these," then I think the issue comes back in front of the Congress at that point in time.

So, I think there is a period where people can look at this, and say, "You know, the bank doesn't want the home back," the finan-

cial institution doesn't want the home—they want the person to stay in it.

But, a lot of times, people have gotten into something they shouldn't have, or were talked into something that they shouldn't have been. We are where we are today, and we all know we've got a problem here, and I just think if we can make the work outs work in substantial numbers across the country, then great. I would presume, really, Senator Durbin would be very happy with that.

If they don't, then it becomes a more difficult matter if these numbers start jumping up. And that would be the point I would like to make to you, on a raw basis.

Secretary PAULSON. Senator, can I respond to that in one way? Because no matter how well we make this program work, given the excesses that were entered into, the foreclosures will jump up. And there are a number of homeowners who were speculators. There were a number of homeowners in hot markets that put very little down, the first time there's some negative equity from their home, they're going to walk away from their obligation.

And I think the very interesting question there—to me, it's not a difficult question, for some it's a more difficult question, to me it isn't—that if someone is going to walk away unless someone else pays for their losses, I don't want it to be the Government or other taxpayers to pay for their losses. To me, those are speculators, and that shouldn't be the focus of our efforts.

Senator BROWNBACK. Fair enough.

Secretary PAULSON. And so, when you look at these foreclosures, I'm focused on the same ones that Chairman Durbin is focused on—in other words, homeowners that want to stay in their home and are having trouble with——

REPATRIATION OF FUNDS

Senator BROWNBACK. I want to build off of that point with the little bit of time that I have here. It certainly strikes me that one of the biggest things we all want to avoid is this soft economy going on into a recession. The economy's soft, credit's tight, and we don't want it to slide on into a recession. I think the administration is trying to do everything they can to stave off a recession.

One of the issues that I want to draw to your attention—I'm sure you've looked at this—is repatriation of funds from large corporations bringing back to the U.S. economy. Last time we did that, that brought in $284 billion in earnings from overseas back into the U.S. economy in a 1-year time period, where normally we'd have about $70 billion in the same 1-year time period. So, nearly a $200 billion infusion into the U.S. economy. I hope the administration would look at something like that as an infusion of cash into the economy, which we need to have at this point in time.

Secretary PAULSON. Senator, I thank you for pointing that out. It's something we've looked at, it's something that I had calls from a number of people I knew in the private sector advocating very hard for that at the time we did the stimulus package. And since we were very rigorous on the stimulus, in terms of saying, "Everything that went in had to be stimulus," there are some things that are very good economic policies, and, you know, I knew from a lot

of experience, just because a company brings cash back, doesn't mean they're going to spend it, okay? And so, we focused much more on things that were going to increase the likelihood that it'll be a real stimulus.

But, I understand the incentives and motivations you're talking about, and the wisdom of something like that, and I thank you for bringing it.

Senator BROWNBACK. Well, it strikes me that we may be getting to a point where we want to put everything out there we possibly can to keep the economy from going into recession. And even if the corporations don't spend it, if it's sitting overseas, they're for sure not going to spend it here.

Secretary PAULSON. Right.

Senator BROWNBACK. You've assured that one of taking place.

So, I think we ought to be looking at the next step on this, just to——

Secretary PAULSON. Right.

Senator BROWNBACK [continuing]. Because things are tough out there, and it looks like, it's going to be difficult for the consumer to come back in the marketplace, to the degree or level that we want. So that's going to depend upon a lot of corporations and individuals investing, us being very competitive with our exports—which have grown substantially.

Secretary PAULSON. Yes.

Senator BROWNBACK. Us expanding the energy industry domestically, I just think now we're looking at some bit of restructuring of our economy, probably a little away from the consumer, and more towards exports, energy—and these are great opportunities for us. I see you put some things on the energy market, here, I hope we can do that.

ALTERNATIVE METALS FOR COINS

And just a final comment—I just hope you don't make the penny out of plastic, or nickel out of plastic. Make it out of some metal.

Secretary PAULSON. Yeah, we're talking about composite metals, right, we're just changing the metal content a bit.

Senator BROWNBACK. All right, thank you. Unless it's wheat-based plastics or something like that.

You know, maybe corn, being from Illinois, but just—don't make it out of plastic.

COUNSELING FUNDING

Senator DURBIN. We have a bipartisan position on that.

Mr. Secretary, when you get back, take a look at the statement of administration policy issued February 26, this year, relative to the housing stimulus bill on the floor, and you'll see that the administration said that it would veto this bill over the suggestion of tripling the funding for the Neighborhood Reinvestment Corporation, which was expressly for more counselors.

Secretary PAULSON. Yeah, I just put in front of me, yeah. You said it's because—I think the view is we've got plenty of funding right now.

Senator DURBIN. Well, I think that—I've been out, locally in Chicago and all around our State, and I think that's arguable. Because

if we are reaching 20 percent, and still have 80 percent, some of that is because of lack of volition on the part of the borrower, but it appears to me that there's a lot more that needs to be done if there's truly going to be an aggressive approach to this.

I would just like to close, and I'm going to give you a chance to respond, because it's—what I'm about to say is critical, and I want to hear your response to it.

When one of your senior counselors was asked yesterday about the Treasury Department report on loan modifications under Hope Now, 45,000 borrowers in January, the senior mortgage banker who runs the Hope Now program said, and I quote, "A mortgage servicers obligation is to get the maximum value to the investor over the life of loan. If you're going to modify the loan and keep the borrower in the house, the bias is to do that for a shorter, rather than a longer, period of time. There's a reluctance to do long-term modifications."

So, I think the 45,000 figure may be misleading. If it's only temporarily suspending the foreclosure, it's not going to help in terms of really trying to right this ship.

My concern from the beginning, is that I know the administration's philosophy, that you have carried out, calls for voluntary involvement by lending institutions. When we suggest bringing in a bankruptcy court to try to force the hand of some of these banks to finally renegotiate, the administration opposes it, and says they'll veto a bill.

I have said, repeatedly, and I won't go into the graphic detail, I don't think that the response to this housing crisis is adequate. I think it is going to continue to get worse. And as long as it worsens, and as long as the housing industry is in such terrible shape across America, it's going to be hard to see a sound economic recovery.

It isn't just the builders, and the speculators, and the land developers, it's all the material men and skilled craftsmen and everyone else who are, frankly, not doing much work in my State of Illinois and around this country, waiting for the housing market to come back. And those of us who own homes are watching the values go down because of foreclosures. And we're watching units of local government that will face serious problems as assessed valuation goes down, and as property tax revenue goes down that's used to sustain local units of government.

If there was ever a time for someone to push away a Herbert Hoover view of this, and say, "We need a New Deal view of this, that says there has to be something that's decisive, and meaningful, and reaches the most number of people as quickly as possible to turn this ship around," I think it's now. And the longer we wait, the worse, I think, it's going to get.

And, I invite your response.

Secretary PAULSON. Well, let me respond to that, and the counseling.

I would say on counseling, I get out a fair amount, and spend time with counselors, I'll be spending some time when I'm out in California later this week, when I was in Chicago, I spent time with NeighborWorks. And at least to date, when I've talked with counseling firms, they're not impeded by a lack of funds, okay?

There's not—and so we're, because I just don't want there to be a difference between us on that. Because this is essential and it is, it's major.

LOAN MODIFICATIONS

Now, in terms of modifications, various firms take various approaches to the modification. But to me, the focus I have is having mortgage servicers make modifications that help people stay in their home, and avoid foreclosure. And that is the objective, it is—I think these are costly things to go through, I don't think it's in the interest of either the borrower or the lender, to have something not be sustainable. All I can say to you is that on that effort, I'm going to drive that as hard as I know how.

Now, in terms of your overall comment, where you talked about Herbert Hoover—there's been a lot that's changed since we went through the Depression and when the foreclosures were 50 percent and unemployment was 25 percent. We have GSEs, we have the FHA, we have the Federal Home Loan Banks, that we're going through a period now where 93 percent of the people in this country, every single month, no matter how hard it is, make their mortgage payment. Two percent—not 50 percent—are in foreclosure.

Now, I believe when you say you think it's going to get worse, I'm not arguing with you. I've said that I think that those forecasters who say that this is an adjustment, a period of adjustment, it's going to take longer to run its course—I agree with them.

You know, when I look at the mortgages that were made in 2006, that are going to be reset over the next couple of years, and when I look at some of the mortgages, the negative amortization mortgages, which will be coming, now, even further out—I recognize that this is going to take longer. And again, I've told you where the focus is, and we're focusing very hard on avoiding preventable foreclosures to those who want to stay in their home, and have the capability to do that.

I appreciate you and I want to do the same thing. I'm going to keep watching this very closely, we're going to be all over it, and I, you know, as again, I know you've got the same objective I do. We've got some—and you're supportive of Hope Now, you're saying you think there should be some other things done——

Senator DURBIN. There should be more.

Secretary PAULSON. And we're just——

Senator DURBIN. Well, let me thank you for coming today and testifying—we didn't talk much about your budget. But you will get plenty of written questions on that, which we will submit to you.

Secretary PAULSON. Thank you.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. And we will provide those for you. And any members who wish to make statements and allow them part of the record, they will be included, and any questions in writing, I ask that you try—I know you're a very busy man, but if you'd try to respond to them in a timely fashion, we would appreciate that very much.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

TRADE

Question. In Illinois, we continue to see losses in manufacturing jobs that can at least in part be attributed to the forces of globalization. The Trade and Globalization Adjustment Assistance Act of 2007 extends Trade Adjustment Assistance (TAA) to services sector workers and workers affected by offshoring, creates a new TAA program for rural and distressed communities, and makes training, healthcare, and wage insurance benefits more accessible and flexible. Does the Administration support strengthening Trade Adjustment Assistance along these lines?

Answer. The Administration strongly supports TAA reauthorization that includes needed reforms to help workers adversely impacted by trade access the training and reemployment services they need to return to work quickly.

Reauthorization provides an opportunity to redesign the TAA program to make it more effective in enabling workers to gain the skills needed to successfully compete in the 21st century global economy.

The Administration believes there are several flaws in the TAA program as it is currently designed. These flaws include:

—TAA is an "all or nothing" program, where participants lose access to benefits by choosing to return to work.

—Training options are limited and the process of applying for training is lengthy and bureaucratic.

—Services cannot be provided until after the worker is laid off—even when the layoff is announced well in advance.

—There is no requirement that One-Stop Career Centers provide "wrap-around" services such as career counseling, assessment and job placement assistance to all TAA participants through the Workforce Investment Act (WIA).

The Administration believes any reauthorization of the TAA program should reflect the following priorities:

—Workers must have increased choice to combine employment with training and "earn while they learn."

—Training options should be flexible and easy to access.

—Services should be available prior to layoff, in order to reduce the length of time workers are unemployed.

—Integration with the Workforce Investment System should be improved by requiring states to ensure workers have access to the full range of services available through the One-Stop Career Centers under WIA.

Question. It is difficult for workers to complete some courses under the current TAA restrictions because it simply takes longer to finish the programs than TAA allows. For example, Illinois has an acute shortage of nurses, and yet the state is unable to find enough people either to teach the training courses or to complete the programs. This is a high-growth area for workers that cannot be readily outsourced. However, our TAA rules make it nearly impossible for displaced workers to enter the nursing profession because the program takes longer to complete that TAA allows for training. Do you support common sense updates to Trade Adjustment Assistance rules that would address difficulties like this?

Answer. The Administration believes that a high priority for TAA reauthorization is that trade-affected workers must have increased individual choice to "earn and learn" by having access to transitional benefits, such as education and training post-employment and transitional income support (in certain cases). Benefits under the program should include a menu of "New Economy Worker Services" that allows the worker to choose the option that best fits his or her individual needs. For example, training-related options should allow a worker to combine either full or part-time work with education and training. Similarly, the reauthorization would ensure greater access to education and training by providing "New Economy Scholarships" to workers that could be used over four years. Additional monies would also be available to workers who need pre-requisites for training in a high demand occupation. The New Economy Scholarship should be portable, enabling certified workers to have access to tuition assistance whether they are unemployed or return to employment. Workers should be able to choose to attend training full or part-time and use the funds for tuition, books, fees and required tools.

INTERNATIONAL SANCTIONS: SUDAN

Question. Does the Bush Administration intend to enforce the Sudan Accountability and Divestment Act, which I worked very hard to pass in conjunction with Chairman Dodd and Chairman Frank over in the House, along with the Ranking Member of this committee, Senator Brownback?

The Treasury Department will provide to Congress the reports called for in Section 10 of the Act. Section 6 of the Act governs the Executive Branch concerning government contracts with companies that conduct certain business operations in Sudan. The Treasury Department intends to comply with that provision once the Federal Acquisition Regulation is updated by the Federal Acquisition Regulatory Council, as provided for in the Act.

If so, why did the Administration issue a signing statement that left in doubt whether that would be the case? If not, why did President Bush sign the bill?

Answer. The Department respectfully recommends that these questions be directed to the White House.

INTERNATIONAL SANCTIONS: CUBA

Question. Do you think that the United States should view the transfer of power from Fidel Castro to his brother Raul as an opportunity to strengthen ties to Cuba? Or do you think our policies of sanctions and non-communication should continue? What benefits are derived from a stay-the-course, status-quo approach to Cuba that would maintain the policy of isolating the Cuban government with economic sanctions? Is any consideration being given to an approach aimed at influencing the Cuban government through an easing of sanctions and increased contact and engagement? If not, why not?

Answer. The United States foreign policy positions are defined by the State Department. The Office of Foreign Assets Control (OFAC) administers and enforces the country sanctions against Cuba, which restrict the flow of funds to Cuba that would otherwise be used to prop up the regime rather than benefit the Cuban people. The Administration's policy has been designed to prevent resources from reaching the regime, which uses its resources to control and oppress the Cuban people. We will continue to monitor developments closely and stand ready, if asked, to assist a genuine Cuban transition government committed to democracy.

REDUCTION IN REQUESTED CDFI FUNDING

Question. Compared to fiscal year 2008, proposed reductions could jeopardize $700 million in private capital for CDFIs that could otherwise be made available to communities and individuals currently facing credit shortages. Why are you recommending such a drastic reduction to a program that demonstrates such a tremendous return on the taxpayer's dollars?

Answer. The fiscal year 2009 President's budget includes over $28 million for the CDFI Fund, which will be used to expand the capacity of financial institutions to provide credit, capital and financial services to underserved populations and communities. Specifically, the CDFI Fund will continue to provide grants, loans and equity investments through the CDFI Program, allocate tax credits through the New Markets Tax Credit Program, and support the CDFI Fund's existing grantees.

The fiscal year 2009 President's budget does not propose funding for the Bank Enterprise Award (BEA) Program. The BEA Program provides funds to for-profit banks based on their past activity, and has not demonstrated that its awards increase lending and financial services in economically distressed communities. The BEA program is in the process of modifying the program's regulations. With these revisions in place, any future BEA funding will encourage future community development activities, rather than reward past activity. This change aligns BEA Program activities with the CDFI Fund's goals and objectives.

In fiscal year 2009 the CDFI Fund will continue to serve Native communities through the CDFI Program; however, the fiscal year 2009 President's budget does not include a separate request for Native Initiatives.

Question. How do you reconcile this proposed reduction with the Administration's concern with the shrinking availability of credit?

Answer. The Department of the Treasury encourages the availability of capital and credit to all communities, including low-income, through a broader system of financial institutions. While the CDFI Fund provides capital and credit to financial institutions serving low-income communities it is not the only source of funding available to these institutions. These intuitions may also receive funds from various federal, state, and local entities, such as the U.S. Department of Health and Human Services, U.S. Department of Agriculture, state economic development agencies, and

local municipalities. Non-government funding sources for these financial institutions include banks, thrifts, credit unions, and non-regulated institutions such as loan funds and community development venture funds.

ECONOMIC STIMULUS REBATES

Question. I understand that you anticipate that IRS will begin sending rebate checks starting in May. When do you project that the payments will have a noticeable positive impact on the economy?

Answer. The first economic stimulus payments will be issued by direct deposit beginning May 2, 2008. The first paper checks will go out beginning May 16, following the schedule outlined below.

STIMULUS PAYMENT SCHEDULE FOR TAX RETURNS RECEIVED AND PROCESSED BY APRIL 15

Direct Deposit Payments	
If the last two digits of your Social Security number are:	Your economic stimulus payment deposit should be sent to your bank account by:
00–20	May 2
21–75	May 9
76–99	May 16
Paper Check	
If the last two digits of your Social Security number are:	Your check should be in the mail by:
00—09	May 16
10—18	May 23
19—25	May 30
26—38	June 6
39—51	June 13
52—63	June 20
64—75	June 27
76—87	July 4
88—99	July 11

Based on the payment schedule, the Department projects that the stimulus will begin to provide a meaningful boost to spending almost immediately and that its effect on economic growth will be felt through the rest of the year. The Department also anticipates that the individual and business tax relief components of the package together could lead to the creation of over half a million jobs by the end of the year.

NEW 24/7 OPERATIONS CENTER

Question. The President's 2009 budget for the department requests $6.2 million for a new Operations Center, which would provide 24/7 capability to monitor the global market. How will the enhanced capabilities of the new Operations Center support Treasury's mission?

Answer. The Department of the Treasury serves the American people and strengthens national security by managing the U.S. Government's finances effectively, promoting economic growth and stability, and ensuring the safety, soundness, and security of the United States and international financial systems.

The global scope of the Department's operations requires a 24/7 response capability. The Treasury Operations Center will act as a fusion center for the receipt, analysis, and dissemination of information critical to the economic well being of the country. It will have enhanced analysis capabilities necessary to monitor international and domestic financial markets, coordinate actions with other Federal agencies, foreign governments, and global financial markets, and manage the Treasury's global operations on a round the clock basis. It will have a capability to integrate open source and classified information that currently does not exist in the Treasury organizational structure. The speed with which financial information is processed and the fact that decisions facing the United States are not limited to weekdays from 9–5, dictate the creation of a 24/7 facility that will protect and enhance the fiscal power and reach of the United States Government.

Additionally, the Treasury Operations Center will act as a communications hub for information directly related to the financial markets as well as to national and world events that affect the markets. This communications hub will tie together the

Treasury program offices with their private sector counterparts, foreign financial ministries, and other federal government entities. The Treasury Operations Center will engage directly with international financial market participants, foreign governments, international financial institutions, and in multinational fora in an immediate time-sensitive manner. Open and secure communications capabilities will be available, as will a 24/7 executive switchboard.

Lastly, the Treasury Operations Center will function as a crisis management center. It will be the hub for activities bringing senior Treasury Department officials together to manage rapidly developing issues affecting the financial community (for example, managing the recent sub-prime mortgage situation and bolstering confidence in the investment banking community). Current financial crises require the Secretary to manage operations on a daily if not hourly basis, as well as implementing policies that affect the future course of the nation's economic health. Open and secure conference rooms will be available, along with fully equipped private office space.

CROSS-BORDER WIRE TRANSFERS

Question. In October of 2006, Treasury's Financial Crimes Enforcement Network released a study that found that it is technically feasible to require financial institutions to report data on wire transfers that cross borders. What is the status of Treasury's efforts to implement reporting of Cross-Border Wire Transfers?

Answer. The Financial Crimes Enforcement Network (FinCEN) continues to study regulatory proposals for the collection of Cross-Border Electronic Transmittals of Funds. FinCEN is currently analyzing the costs and benefits of a proposed regulation that will affect law enforcement and regulatory agencies, and the financial industry. Upon completion of the study, a report will be provided to the Secretary for review and consideration.

Question. Have you conducted any analyses in order to weigh the additional costs that data reporting on cross border wire transfers might impose on the financial sector against the benefits of gathering this data?

Answer. As mentioned above, FinCEN is actively engaged in a review of the costs and benefits of a proposed regulation to collect Cross-Border Electronic Transmittals of Funds. Data collection efforts that contribute to the evaluation of costs and benefits include surveys, in-person interviews, and "use case scenarios." Specifically, FinCEN has reached out to affected parties of the Bank Secrecy Act Advisory Group (BSAAG), a statutorily created forum for discussing Bank Secrecy Act (BSA) administration, to assess the impact on industry. FinCEN has also coordinated with the Federal Reserve Board to survey financial institutions that transmit funds internationally. This voluntary survey asked institutions to identify the impact of a reporting requirement, including the cost of reporting such information. Finally, FinCEN conducted in-person interviews with law enforcement and regulatory agency officials and collected "use case scenarios," which are specific examples of exactly how the agencies would use the cross border data and its resulting benefits.

BUDGETARY IMPLICATIONS OF CUBA SANCTIONS

Question. How many fiscal year 2008 budget and staff resources (stated in dollars and actual staff, either part-time or full-time, and work location) are presently designated for administering the Cuba sanctions? What proportion of total Treasury/OFAC resources do those levels represent?

Answer. Most of OFAC's Cuba-related work is centered in its Licensing Division and includes processing applications for travel to Cuba to market and sell agricultural products to Cuba as provided for by the Trade Sanctions Reform and Export Enhancement Act of 2000, as well as applications to engage in family and religious travel and other Cuba-related transactions. Of the 155 OFAC FTE, six FTE (approximately $1.1 million) in Washington, DC and five FTE (approximately $.9 million) in Miami, FL are devoted full-time to the Cuba program. These eleven FTE represent approximately seven percent of OFAC's budget. In addition, some other individuals, including supervisors, who dedicate time to one or more of the other 20-plus sanctions programs administered by OFAC, work on aspects of the Cuba program as necessary.

Question. How do those levels compare to the resources that are devoted to the other sanctions programs that OFAC implements, including sanctions related to terrorism, weapons proliferation, and narcotics trafficking?

Answer. The balance of OFAC's budget (approximately ninety-two percent) is devoted to the other 20-plus sanctions programs that OFAC implements, including those related to Iran, Sudan, terrorism, weapons proliferation, and narcotics trafficking. However, as noted in the response to the question above, some individuals,

including supervisors, who dedicate time to one or more of the other sanctions programs administered by OFAC, work on certain aspects of the Cuba program as necessary.

Within OFAC's Designations Investigations Division, there are currently six FTE (two of which are currently vacant) devoted full-time to administering counter-terrorism sanctions programs; eight FTE devoted full-time to administering counter-proliferation sanctions programs; eleven FTE devoted full-time to administering counter-narcotics sanctions programs; and eight FTE (two of which are currently vacant) devoted full-time to administering country/regime sanctions programs. These figures are fluid and the resources assigned to administer these programs can change at any time to accommodate foreign policy interests and national security priorities. The FTE within the other operating divisions (Licensing, Policy, Compliance, Civil Penalties and Enforcement) are not assigned to administer and implement specific sanctions programs; rather, these divisions assign employees on a cross-program basis.

It should be further noted that in 2005, as part of the creation of the Office of Terrorism and Financial Intelligence, twenty-three analysts assigned to OFAC's terrorism sanctions program in the Foreign Terrorist Division of OFAC were transferred to Treasury's Office of Intelligence and Analysis (OIA) to form the nucleus of OIA's analytic team. These analysts have continued to support OFAC's counter-terrorism sanctions program through in-depth targeting, research, analysis, and drafting of evidentiaries. Over time, the number of analysts assigned to counter-terrorism work in OIA has grown to thirty-five, strengthening and deepening Treasury's counter-terrorism sanctions program and also allowing OIA to provide expanded analytical support to the Treasury Department and interagency community on terrorist financing matters.

Question. How do the fiscal year 2008 levels (resources and staffing) compare to funds and personnel devoted to Cuba efforts in the previous four fiscal years (fiscal years 2004 through 2007)?

Answer. In fiscal year 2008, OFAC employed new strategies on Cuba matters in the Enforcement and Civil Penalty divisions that have reduced and are expected to continue to reduce resources committed to Cuba; specifically, OFAC increased its targeting of enforcement efforts by concentrating on those facilitating illegal travel to Cuba. It is expected that the percentage of staff time expended by the Enforcement and Civil Penalties divisions on Cuba matters will decrease as a result of the new strategies being deployed. Resources and staffing devoted to Cuba will otherwise remain consistent with the previous four fiscal years (fiscal years 2004 through 2007).

Question. Please provide the Subcommittee with a data table detailing the resources (dollars and personnel) allocated for fiscal year 2008 for investigating and penalizing violations of the Cuba embargo, describing the types of activities involved, and specifying, for comparison purposes, the amounts dedicated to each of the other 20-plus sanctions programs that OFAC administers.

Answer. As noted above, OFAC has adopted new strategies with respect to sanctions violations in recent years. These strategies have resulted in a significant reduction in Cuba penalty cases. Enforcement resources committed to Cuba are also being reduced and enforcement efforts are being targeted in a more effective way by concentrating on those facilitating illegal travel to Cuba. The data table below identifies the FTE within OFAC that are devoted to administering and implementing the Cuba program for fiscal year 2008.

As previously noted, some individuals, including supervisors, who dedicate time to one or more of the other 20-plus sanctions programs administered by OFAC, work on aspects of the Cuba program as necessary. Because of the significance and demands related to the other programs to which these individuals are assigned, OFAC does not track their time spent on the Cuba program. For comparison purposes approximately ninety-two percent of OFAC's budget is devoted to other sanctions programs that OFAC implements, including sanctions related to Iran, Sudan, terrorism, weapons proliferation, and narcotics trafficking.

FISCAL EYAR 2008

[Dollars in thousands]

Divisions with FTE dedicated to a specific program [1]	Cuba		All other programs		Total	
	FTE	Dollars	FTE	Dollars	FTE	Dollars
Licensing	11	$1,969	.....	.....	11	$1,969

FISCAL EYAR 2008—Continued

[Dollars in thousands]

Divisions with FTE dedicated to a specific program [1]	Cuba		All other programs		Total	
	FTE	Dollars	FTE	Dollars	FTE	Dollars
Designations Investigations:						
Counterterrorism	.....	.....	6	$1,041	6	1,041
Counterproliferation	.....	.....	8	1,388	8	1,388
Counternarcotics	.....	.....	11	1,909	11	1,909
Country/regime	.....	.....	8	1,388	8	1,388
Total	11	1,969	33	5,726	44	7,695

[1] As noted above, OFAC's other operating programs assign FTE on a cross-program basis rather than to a particular sanctions program.

MANAGEMENT OF TREASURY'S IT SYSTEMS

Question. The Inspector General's 2008 Annual Plan repeats a continuing concern with the Department's management of large capital investments—particularly information technology (IT) investments. While this is a challenge for any organization, the Department has had particular problems in this area. How are you addressing these deficiencies from a department-wide perspective? What measures and procedures are in place to ensure the success of new systems?

Answer. Over the past year, the Department has taken a number of significant steps to address the IT management challenges. The Department's strategy has focused on three key elements: (1) regular engagement of the Treasury Department and Bureau executives in the management of IT; (2) more rigorous planning and management of IT projects; and (3) improved IT investment review and evaluation tools, processes and practices.

In order to better engage executives across Treasury and its Bureaus, the Department has revitalized the Executive Investment Review Board (E-Board), which was a key recommendation by the Government Accountability Office's July 2007 report (GAO–07–865). The E-Board was re-chartered in December 2007 and held its first meeting in February 2008. The E-Board is chaired by the Deputy Secretary and is comprised of the heads of each of the Department's Bureaus. The Assistant Secretaries for Management and Legislative Affairs, the General Counsel and the Chief Information Officer (CIO) also participate on the E-Board. The E-Board is tasked with ensuring the Department's IT portfolio decisions are driven by Treasury's business requirements and that each Bureau and the Department have in place appropriate planning, monitoring and evaluation mechanisms. The E-Board will also identify strategic priorities for IT use and address Department-wide IT policy issues as they arise.

To improve the effectiveness of planning and management of IT projects, the Treasury CIO has issued new policy and guidance regarding requirements for project planning in order to receive CIO endorsement for funding. The CIO, in collaboration with the Treasury Chief Procurement Executive, has drafted a new IT acquisition policy to strengthen the Department's IT contract management. The Department is working with the bureaus to implement the new OMB required, Federal Acquisition Council Project and Program Management qualifications to ensure that the Treasury federal staff that oversee our IT projects have the appropriate knowledge and skills required to successfully deploy and manage Treasury IT systems. Finally, the Department continues to strengthen its ability to defend against cyber attacks and protect the sensitive information entrusted to the Treasury by the public.

Another element of the Department's overall IT management strategy is to improve the review and evaluation of Treasury IT investments. Rigorous review at both the bureau and Department level is a prerequisite for successful deployment and management of IT systems. In addition, the Treasury CIO has taken action to improve the Department's visibility into and influence on IT projects. In the fall of 2007, the Treasury CIO made the decision to require non-major investments to participate in a process similar to the Department's formal selection and review processes for major investments. As a result, all IT investments (both major and non-major) are considered during the portfolio selection process that is integrated with the Department's budget request. Likewise, bureaus must report quarterly for all IT investments (both major and non-major) on cost, schedule, and performance goals. Finally, the Treasury CIO is expanding its IT investment evaluation process to assess not only "completed" projects against planned objectives, but also those

portions of IT developmental projects that have implemented discrete operational components.

Question. The President's fiscal year 2009 budget requests $2.9 million to fund an upgrade to the IT system used for financial reporting under the Bank Secrecy Act. In July 2006, FinCEN halted work on BSADirect, the previous attempt to upgrade its IT systems. Treasury spent two years of planning and $14.4 million on that failed system. What improvements have you made to the planning and implementation process that will avoid problems that plagued the previous failed upgrade?

Answer. During fiscal year 2007, FinCEN made significant progress on the full range of organizational, program management, and technical architecture-related efforts needed to modernize the bureau's IT systems. FinCEN identified the specific action items in its October 2006 Information Technology Plan, created in response to the BSA Direct project termination. In fiscal year 2007, FinCEN launched an effort to establish the organization's first enterprise business transformation and IT modernization strategy, which serves as the roadmap for aligning FinCEN's IT portfolio with business objectives and processes. FinCEN also expanded its capacity for executing complex IT projects by (1) hiring new project managers; (2) introducing management tools and techniques through the creation of a Project Management Office; (3) establishing a Data Management Framework to improve the management and visibility of BSA data issues; (4) awarding a performance-based contract for acquiring IT services; (5) and strengthening collaboration with internal and external stakeholders. FinCEN is also fully engaged in Treasury's revised processes in the question above.

Question. The President's fiscal year 2009 budget requests $3 million for a new debt management system. Treasury reports that the new system will enhance the efficiency of federal borrowing, which will save taxpayers money. How much do you estimate that the current system is costing taxpayers? What kind of return will the taxpayers get on this investment?

Answer. Currently, Treasury's Office of Debt Management (ODM) spends approximately $600,000 annually to manage its $9+ trillion liability portfolio. Given the size of the portfolio, ODM believes there is significant opportunity cost foregone due to its current outdated IT infrastructure and modeling capabilities which limit sophisticated portfolio analysis.

Treasury issues $4.3 trillion of debt per year using basic Excel spreadsheets and manual operations. The current size of Treasury's marketable debt portfolio is $4 trillion, with an annual interest cost of $244 billion in 2007. The additional funds to improve ODM's systems will make a huge difference in costs. For example, if the Department can issue just $1 billion less over a one month period due to better portfolio analytics and sound modeling capabilities, Treasury would save $3 million at current interest rates. Over the long term, the Department could potentially save one one-hundredth of a percent (.0001) on the $4 trillion marketable debt portfolio, resulting in potential interest costs savings of over $400 million annually. We believe this cost saving is conservative, and that additional savings are eminently possible given better risk management systems and operations.

More importantly, for global financial markets, a disruption in the ability to make debt issuance decisions or the inability to function in the event of a contingency event would precipitate severe financial distress and cost. Since every fixed income market in the world is tied to the Treasury market, such disruption would be significantly costly from a financial perspective.

The proposed systems would provide: (1) a robust infrastructure on top of the new Treasury auction system (providing 24/7 reliability, back office servicing, and applications development), (2) a secure contingency site with numerous business continuity options, (3) the ability to remotely access and make debt issuance recommendations, (4) the ability to make informed debt issuance decisions using advanced portfolio analytics, (5) the ability to provide key interest rate data to Congress as mandated and to financial markets as necessary without interruption, and (6) major infrastructure upgrades (including servers which are severely antiquated). The immediate implementation of these systems is necessary for the national and financial security of the United States.

COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS)—CASELOAD MANAGEMENT

Question. The Foreign Investment and National Security Act of 2007 became law in July of 2007, increasing Congressional oversight of the CFIUS review process. How is the Department preparing to meet the increase in requirements under the new law?

Answer. CFIUS and Treasury have been in compliance with the requirements of the Foreign Investment and National Security Act (FINSA) since FINSA became effective in October 2007. To ensure that Treasury and all CFIUS agencies comply fully with FINSA and meet the increased Congressional oversight requirements that it presents, the Department has made multiple changes and taken multiple steps, which include: increases in staffing levels, increases in accountability, and higher level cooperation between CFIUS agencies and agencies outside of the CFIUS process.

Regarding staffing, Treasury and other CFIUS agencies have substantially increased staffing for CFIUS-related issues. In Treasury, we established a new Deputy Assistant Secretary position focused on CFIUS issues and reporting to the Assistant Secretary and the Under Secretary for International Affairs. Treasury has also hired additional staff to handle the increased requirements, including reporting requirements under FINSA and the increased case load. The total number of full-time staff assigned to work on investment security issues in Treasury has nearly tripled, rising from 5 full-time positions to 14.

On accountability, CFIUS has implemented formal processes to ensure that CFIUS matters are fully considered at the highest levels. This includes strong internal procedures to ensure that every case is certified at the Assistant Secretary or Deputy Secretary level, as appropriate, that the required post-review or post-investigation certifications are submitted to Congress in a timely manner, and that requested briefings are provided to Congress as required.

On coordination, Treasury (in consultation with other CFIUS agencies) has issued internal CFIUS guidelines to ensure that the reporting requirements under FINSA are fully satisfied in a timely manner. CFIUS agencies meet each week to discuss and deliberate on all cases before CFIUS, and where appropriate, outside agencies and departments (such as the Departments of Transportation and Health and Human Services, and NASA) are called on to bring their expertise into the CFIUS process. Improvements have also been made in intelligence analysis, which is now being coordinated by the Director of National Intelligence, who is consulting with each of the key intelligence agencies in the U.S. government. Further, the Executive Order issued by the President on January 23, 2008, establishes executive branch rules to ensure that CFIUS is able to meet the reporting requirements under FINSA in an efficient and orderly manner. Treasury is coordinating with other CFIUS agencies to submit the required annual report to Congress by July 31, 2008.

Question. I understand that the CFIUS caseload has increased over the last few years. Why are we seeing such a dramatic increase, and how is Treasury adapting to respond to this increase while ensuring that the CFIUS cases are completed in a reasonable time frame?

Answer. There are numerous reasons for the recent increase in the CFIUS caseload, including the rate of foreign direct investment into the United States, heightened public awareness of the CFIUS review process following several high-profile cases in recent years, and increased recognition among businesses that certain transactions could raise national security considerations in the current security environment. In addition, there have been a number of "defensive" filings where there is a cross-border acquisition that has little relevance to national security.

In the last few years, Treasury has made numerous organizational and procedural improvements to ensure that all cases continue to be processed efficiently, with all national security considerations fully analyzed. As noted above, Treasury established a new Deputy Assistant Secretary position in 2006 focused on CFIUS issues. Treasury has also hired additional staff to focus on CFIUS issues. Meanwhile, the increased caseload requires additional resources to be dedicated to CFIUS matters. The regulations and guidance that Treasury will be publishing this spring will also help ensure an efficient process.

Further, CFIUS agencies have made it clear to companies and their advisors that, where appropriate, advance pre-filing briefings and consultations ensure that CFIUS has adequate time for reviews.

INTEGRATION OF TREASURY INTO U.S. INTELLIGENCE COMMUNITY

Question. How well is the Office of Terrorism and Financial Intelligence being integrated in the intelligence community?

Answer. Since its creation in 2004, the Office of Intelligence and Analysis (OIA)—Treasury's Intelligence Community (IC) component—has become a fully-integrated member of the IC. OIA is recognized as a key player in IC efforts to address the financial underpinnings of national security threats and threats to international financial stability. The Assistant Secretary for Intelligence and Analysis is a member of the Director of National Intelligence's (DNI) Executive Committee (the IC's

"Board of Directors") and OIA is an active participant in the various working groups and committees guiding IC efforts against key threats, including the National Intelligence Analysis Production Board, the Counterterrorism Advisory Group, the IC Leadership Council, the WMD–T Steering Group, and the Interagency Intelligence Committee on Terrorism. The Office of the Director of National Intelligence recently acknowledged OIA's status as a key IC figure by asking it to serve as the National Intelligence Priorities Framework Topic Expert for Economic Stability and Financial Networks.

OIA routinely coordinates on (and provides input to) articles drafted for the National Terrorism Bulletin (NTB) and the President's Daily Brief. In addition, OIA provides regular support to the Federal Bureau of Investigations (FBI) counterterrorism investigations, and frequently offers input to counterterrorism and counterproliferation analytic products drafted by the FBI, the Central Intelligence Agency (CIA), and other IC agencies. On numerous occasions, OIA analysts have drafted intelligence reports jointly with their counterparts at the FBI and CIA. In order to strengthen cooperation with these agencies, OIA has detailed officers to the FBI's Terrorist Finance Operations Section and to the CIA. OIA also has officers forward-deployed to U.S. Central Command, U.S. Pacific Command, U.S. European Command, and the joint Treasury-DOD Iraq Threat Finance Cell in Baghdad. OIA is in the process of identifying an officer to serve as Treasury's representative to the DNI's National Intelligence Coordination Center (NIC–C). The Defense Intelligence Agency, and the National Security Agency have assigned officers to OIA to facilitate cooperation and information sharing.

Question. What improvements are needed to maximize the ability of Treasury and other components of the intelligence community to exchange critical information?

Answer. OIA's fiscal year 2009 Global Finance Initiative (GFI) would give Treasury the resources it needs to successfully leverage its status as a fully-integrated member of the IC. GFI would provide $2 million, including a realignment of $1 million in Department base resources, and 10 positions to establish a capability in OIA to advance global finance intelligence issues within the IC. Resources would be targeted to: (a) aligning IC collection requirements on finance-related issues more closely with policymaker needs, (b) developing and taking advantage of new sources of information, (c) enhancing analysis on finance-related issues in coordination with the IC, and (d) expanding OIA's role and relationships within the IC. This initiative is aligned with key tasks and objectives of the National Security Strategy, the National Intelligence Strategy, the National Implementation Plan for the War on Terror, and the Treasury Strategic Plan.

GFI would enhance the effectiveness of IC collection and analysis on global financial networks. Addressing global financial networks involves assessing the financial underpinnings of national security threats, identifying our adversaries' financial vulnerabilities, measuring the impact of targeted financial measures, and uncovering threats to the stability of the international financial system. By assuming a greater role in guiding financial intelligence collection and analysis, OIA would address a growing need in the IC, and take a large step toward meeting the expectations of Congress and Treasury leadership when they created OIA.

Question. What organizational, technical, or other types of barriers hamper the ability of the office to fit successfully into the overall intelligence community, and how are those impediments being addressed?

Answer. Since its creation in 2004, the Office of Intelligence and Analysis (OIA)—Treasury's Intelligence Community (IC) component—has made great strides in its efforts to integrate itself into the IC. OIA is recognized as a key player in IC efforts to address the financial underpinnings of national security threats and threats to international financial stability. OIA's fiscal year 2009 Global Finance Initiative (GFI) would give Treasury additional resources for aligning collection requirements on finance-related issues more closely with policymaker needs; developing and taking advantage of new sources of information; enhancing analysis on finance-related issues in coordination with the IC; and expanding OIA's role and relationships within the IC.

Despite these advancements, OIA faces significant challenges in hiring highly qualified analysts. The conventional hiring process is cumbersome and lengthy, and competition within the Intelligence Community for qualified candidates is fierce. The Treasury Department strongly supports section 121 of the fiscal year 2009 Intelligence Authorization Bill, which establishes the authority to convert positions within the intelligence component of the Treasury Department, DHS, and other departmental intelligence components to excepted service status, which would go a long way towards leveling the playing field.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Could you give us an update on how your "HOPE NOW alliance" is working to prevent further foreclosures in the nation's housing market?

Answer. Treasury is pleased with progress of the HOPE NOW Alliance, a private group of lenders, servicers, non-profit counselors and trade organizations that was initially facilitated by Treasury and HUD. However, we recognize more work remains. As of February 29, 2008, the industry had helped almost 1.2 million homeowners find alternatives to foreclosure through either a loan modification or repayment plan since July of 2007. These data do not include refinancing statistics. Of particular significance is the fact that modifications are continuing to rise as a proportion of work-outs. In February alone, 39,000 subprime borrowers received loan modifications. Modifications accounted for more than 38 percent of borrower workout plans in February, up from just under 19 percent in July 2007. In total, the three-month rate of change in modifications was up approximately 40 percent in February, while the rate of change in foreclosure starts was up only 16 percent.

FHA has also aided HOPE NOW's efforts and played a vital role in helping more current and delinquent homeowners find affordable solutions. The recent announcement to expand FHA Secure to more delinquent borrowers will enable FHA to refinance an additional 100,000 homeowners this year. In total, FHA Secure is estimated to refinance up to 500,000 homeowners by the end of 2008.

Through a variety of outreach tools and operational best practices established by HOPE NOW, Treasury believes the Alliance has laid the groundwork for increased success in the coming months.

It is imperative that HOPE NOW continue to improve on its progress to date, and Treasury will be sure to consistently convey that message to the Alliance.

Question. What are your thoughts on the Durbin Bankruptcy bill that would allow judges to re-write loan provisions? What would be the effects on the banking system of the provisions of this bill?

Answer. While Treasury respects the efforts of Senator Durbin to explore potential solutions for the current mortgage market downturn, Treasury is concerned about the unintended consequences such legislation may have on the mortgage market in going forward.

Amending the bankruptcy code in this manner would undermine existing contracts, leading to a contraction in available and affordable mortgage credit. This bankruptcy provision would rewrite certain tenets of bankruptcy law in ways that would fundamentally alter the expectations of parties to thousands of home purchases after the fact. These provisions would also likely prolong the time it will take the market to recover from the current downturn.

Question. I understand that the World Bank is sending U.S. taxpayer funds to Iran through banks that we have already sanctioned as WMD proliferators. What is the Treasury Department doing to try to stop this from happening, since it is contrary to everything we are trying to accomplish with our Iran policy?

Answer. The Administration shares Congressional concern with the deceptive practices of Iranian financial institutions and the involvement of these institutions in proliferation activities. The Treasury Department has been a leader in singling out Iranian banks for sanctions as a result of their illicit activities.

The Department has worked closely and diligently with the World Bank to ensure that it is fully abreast of the evolving sanctions being put in place by the United Nations Security Council, the inter-governmental Financial Action Task Force (FATF), and the most recent Treasury Department designation of Future Bank as being controlled by Iran's Bank Melli.

The Administration has taken and will continue to take an active role in opposing World Bank lending to Iran. The United States has opposed every proposal for Iran since the early 1980s. However, despite these efforts, projects have been approved by the 24-member Board and continue to disburse funds. The Department has been assured that disbursement of loan proceeds under these World Bank-financed projects and the project accounts have been transferred to commercial banks which are neither on the list of entities sanctioned pursuant to the U.N. Security Council resolutions nor on the list of entities sanctioned for nuclear proliferation activities by the U.S. Treasury. When making such disbursements, the World Bank screens the list of beneficiary entities as well as financial intermediaries against the U.N. list maintained pursuant to the aforementioned U.N. Security Council decisions, and the list maintained by the Treasury Department's Office of Foreign Assets Control (OFAC).

The Treasury Department will continue to strongly oppose and vote against any World Bank Group loan or other type of assistance to Iran and will also ensure that

the Bank continues to comply with the full range of sanctions regimes to avoid any activity that could facilitate Iran's nuclear or missiles programs.

Question. We have enacted legislation to allow States to divest from Sudan. What are your thoughts on allowing States to divest from Iran?

Answer. The Administration shares Congressional concern with the conduct of the Iranian regime, and the Treasury Department has played a leading role in seeking to isolate Iran financially. Such efforts targeting Iran are most likely to succeed if they are multilateral in nature, and much of our effort has been targeted at persuading our allies and private sector institutions to cut back or terminate their financial dealings with Iran. The multilateral efforts that resulted in the recent United Nations Security Council Resolution with respect to Iran (U.N. Security Council Resolution 1803, passed March 3, 2008) are but one example of the cooperation we are receiving from our allies abroad. Legislation authorizing divestment from companies that do business in Iran risks alienating the very allies whose assistance we need. It also limits the President's ability to conduct U.S. foreign policy with one voice.

Question. You've asked for some increases in your budget for the Office of Terrorism and Financial Intelligence. Can you update us on the progress you have made in cutting off funds to terrorist organizations and rogue nations?

Answer. The Office of Terrorism and Financial Intelligence (TFI) has made significant progress in this area by using a combination of financial measures, fueled by financial intelligence, in a way that engenders the support of other governments and the private sector. TFI has successfully drawn on a range of tools for this effort, including executive orders issued by the President pursuant to the International Emergency Economic Powers Act, Section 311 of the USA PATRIOT Act, and FinCEN advisories. Combining these authorities with targeted intelligence about illicit financing networks, TFI has used conduct-based, intelligence-grounded, targeted financial measures to address the threat of terrorist organizations and rogue nations in a way that encourages support from both the private sector and larger international community.

Executive Order (E.O.)13224 has proven to be a powerful and flexible tool for targeting terrorist organizations, allowing the Department to block the assets of individuals and entities controlled by or acting on behalf of named terrorist organizations, freezing any of the target's assets that are held by U.S. persons and preventing U.S. persons from having any future dealings with them. To date, the United States has designated 486 individuals and entities pursuant to E.O. 13224, of which nearly 400 were named by Treasury. In addition, 19 individuals and entities have been designated pursuant to E.O. 12947, which prohibits transactions with terrorists who threaten the Middle East peace process.

Treasury has also drawn on this range of tools to influence the conduct of rogue nations like North Korea, using targeted financial measures and systemic controls like those previously described. In the case of North Korea, the Department took two important actions to address conduct ranging from WMD proliferation-related activities to counterfeiting of U.S. currency and other illicit behavior. First, a number of North Korean proliferation firms were targeted under E.O. 13382. That Order authorizes the Treasury and State Departments to target key nodes of WMD and missile proliferation networks, including their suppliers and financiers, in the same way as is done with terrorists. A designation under this order cuts the target off from access to the U.S. financial and commercial systems and puts the international community on notice about a particular threat. Second, regulatory action was taken to protect the financial system against Banco Delta Asia (BDA). In September 2005, Treasury designated BDA as a primary money laundering concern. At that time, Treasury issued a proposed rule, which was subsequently finalized in March 2007, prohibiting U.S. financial institutions from opening or maintaining correspondent accounts for or on behalf of BDA. Treasury took this step to protect the U.S. financial system from BDA, which exhibited systemic failures in its application of appropriate standards and due diligence, as well as its facilitation of unusual or deceptive financial practices by North Korean-related clients. In addition to protecting the U.S. financial system from the significant vulnerability that BDA represents, the Section 311 action has spurred improvements in Macau's regulatory environment. Following the BDA action, the Macanese authorities took substantial steps to strengthen Macau's anti-money laundering and counter-terrorist financing regime, notably by passing a new law to strengthen these controls and starting the jurisdiction's first-ever Financial Intelligence Unit (FIU). Perhaps most importantly, the action against BDA has had a profound effect, not only in protecting the U.S. financial system from abuse, but also in notifying financial institutions and jurisdictions globally of an illicit finance risk. Following these actions, responsible foreign jurisdic-

tions and institutions have taken steps to ensure that North Korean entities engaged in illicit conduct are not receiving financial services.

Question. You have identified the targeting of state sponsors of terrorism such as Iran and Syria as an immediate challenge for the Office of Terrorism and Financial Intelligence (TFI). What can you tell us about those activities and the progress you have made so far?

Answer. TFI has taken important steps with both Iran and Syria by using a combination of financial measures, fueled by financial intelligence, to target their conduct in a way that engenders the support of other governments and the private sector.

Syria.—Targeted financial measures have proved effective in addressing the threat Syria's problematic behavior poses to the United States. To respond and take additional measures to address this threat to our national security, foreign policy, and economy, President George W. Bush issued E.O. 13460 on February 13, 2008. This measure targets individuals and entities determined to be responsible for or who have benefited from the public corruption of senior officials of the Syrian regime. On February 21, 2008, the Treasury used this authority to designate Rami Makhluf, a powerful Syrian businessman and regime insider whom improperly benefits from and aides the public corruption of Syrian regime officials. In addition to this use of targeted economic sanctions against Syrian entities involved in WMD proliferation, Treasury has taken action under Section 311 to protect the U.S. financial system against the Commercial Bank of Syria (CBS), which has been used by criminals and terrorists to facilitate or promote money laundering and terrorist financing, including the laundering of proceeds from the illicit sale of Iraqi oil and the channeling of funds to terrorists and terrorist financiers. In March 2006, Treasury issued a final rule, pursuant to Section 311, designating CBS as a "primary money laundering concern" and requiring U.S. financial institutions to close correspondent relationships with CBS. Consequently, prominent international financial institutions have begun to reassess their relationships with Syria and a number of Syrian entities.

Iran.—Due to U.S. concern about Iran's well-documented illicit behavior, the Treasury Department maintains broad sanctions against Iran (measures that build upon our overall and long-standing Iran policy). U.S. commercial and financial sanctions against Iran, as administered by OFAC, prohibit U.S. persons from engaging in a wide variety of trade and financial transactions with Iran or the Government of Iran, and prohibit most trade in goods and services between the United States and Iran, and any investments by U.S. persons in Iran. U.S. persons are also prohibited from facilitating transactions via third-country persons that they could not engage in themselves. Against this backdrop of long-standing sanctions against Iran, Treasury has taken a number of actions to address the threat of Iranian proliferation activity in recent years.

First, while under our general Iran country sanctions program, Iranian financial institutions are prohibited from directly accessing the U.S. financial system, they are permitted to do so indirectly through a third-country bank for payment to another third-country bank in transactions not involving the United States or U.S. persons. In September 2006, OFAC cut off one of the largest Iranian state-owned banks, Bank Saderat, from any access, including this indirect, or "u-turn," access to the U.S. financial system. This bank, which has approximately 3,400 branch offices, is used by the Government of Iran to transfer money to terrorist organizations. As noted below, OFAC later designated Bank Saderat for its support for terrorist groups.

Second, OFAC is relying increasingly on the targeted financial measures to combat Iran's pursuit of nuclear capability, development of ballistic missiles, and its support for terrorism. With respect to Iran, OFAC has been able to apply these measures in the context of U.N. Security Council Resolution (UNSCR) 1737 and 1747, enabling the Department to secure greater multilateral implementation by governments and the private sector and use targeted financial measures against Iranian individuals and entities in both our counterterrorism and counterproliferation sanctions programs. Treasury took several major actions under these programs in October 2007, building on previous successes with designations of Iranian entities supporting proliferation using U.S. unilateral authorities and at the United Nations. On October 25, 2007, Treasury and State (acting in tandem) were able to expose Iranian banks, companies, and individuals that had been involved in proliferation and terrorism-related activities and cut them off from the U.S. financial system. These actions included making:

—Treasury designations of two of Iran's state-owned banks (Banks Melli and Mellat) and three individuals affiliated with Iran's Aerospace Industries Organization (AIO) for proliferation activities under E.O. 13382;

—Treasury designations of nine Islamic Revolutionary Guard Corps (IRGC)-affiliated entities and five IRGC-affiliated individuals as derivatives of the IRGC under E.O. 13382;
—The designation of the IRGC-Qods Force (IRGC–QF) under E.O. 13224 for providing material support to the Taliban and other terrorist organizations; and
—The designation of Iran's state-owned Bank Saderat as a terrorist financier.

Many of the U.S. designations against Iranian entities and individuals under E.O. 13382 have been similarly designated under UNSCR 1737 and UNSCR 1747. Most recently, UNSCR 1803 added additional names to the growing list of Iranian individuals and entities that are subject to multilateral targeted financial sanctions. UNSCR 1803 also includes a warning regarding Iranian financial institutions more generally, establishing obligations for U.N. member states to exercise vigilance over their own financial institutions activities with financial institutions domiciled in Iran, and their branches and subsidiaries abroad. The Resolution further names two Iranian financial institutions that Treasury previously designated, Bank Melli and Bank Saderat, as institutions of particular concern.

Third, in addition to these "formal" actions, the Treasury has engaged in unprecedented, high-level outreach to the international private sector, meeting with more than forty banks worldwide to discuss the threat Iran poses to the international financial system and to their institutions. Through this outreach, OFAC has shared information about Iran's deceptive financial behavior and raised awareness about the high financial and reputational risk associated with doing business with Iran. The use of targeted measures has aided this effort by highlighting specific threats, helping isolate these bad actors, and preventing them from abusing the financial system. By thus partnering with the private sector, there is an increasingly less desire to work around sanctions. Even those institutions not formally bound to follow U.S. law pay close attention to the targeted actions and often adjust their business activities accordingly. Many leading financial institutions have scaled back dramatically, refused to issue new letters of credit to Iranian businesses, or even terminated their Iran-related business entirely. They have done so of their own accord, many concluding that they did not wish to be the banker for a regime that deliberately conceals the nature of its dangerous and illicit business.

TFI has also communicated with the U.S. financial sector regarding Iran through the issuance of advisories. In October 2007, following a statement by the FATF on the threat posed by deficiencies in Iran's anti-money laundering/combating the financing of terrorism regime, the FinCEN followed suit by issuing an advisory to alert U.S. financial institutions of similar concerns regarding Iran. In this advisory, FinCEN advised that financial institutions should be particularly aware that there may be an increased effort by Iranian entities to circumvent sanctions and related financial community scrutiny through the use of deceptive practices involving shell companies and other intermediaries or requests that identifying information be removed from transactions. The advisory went on to explain that such efforts may originate in Iran or Iranian free trade zones subject to separate regulatory and supervisory controls, including Kish Island. Such efforts may also originate wholly outside of Iran at the request of Iranian-controlled entities.

Question. Treasury's Office of Intelligence Analysis was established in fiscal year 2005. Since that time, how has it contributed to overall intelligence collection?

Answer. OIA has limited authority to collect foreign financial and monetary information, and general foreign economic information. OIA's primary mission is to analyze intelligence collected by other agencies in order to support the formulation of Treasury policy and the execution of its authorities. To support its mission, OIA leadership firmly believes that the organization should drive intelligence collection by providing timely and insightful analytic support to IC members engaged in clandestine and open-source intelligence activities. OIA analysts routinely provide their intelligence requirements to collectors at the Central Intelligence Agency, the National Security Agency, the Federal Bureau of Investigation, the Defense Intelligence Agency, and other IC elements in order to help those organizations more effectively direct their resources. OIA also provides feedback to IC Collectors as to the timeliness, relevance, and accuracy of the information provided by their sources. All in all, this support helps ensure that scarce IC collection resources are focused on the hardest targets and finance-related collection requirements are closely aligned with policymaker needs.

In fiscal year 2008, OIA is expanding its ability to drive collection by increasing its cadre of dedicated Requirements Officers. OIA's fiscal year 2009 Global Finance Initiative (GFI) would provide additional resources to ensure that each of OIA's core mission areas receives dedicated collection requirements support.

Question. Question from the Republican Staff Director of the JEC:

Recent turmoil in financial markets is continuing, particularly the markets for asset backed debt instruments. It's clear that in many instances debt that received a AAA-rating was in fact not AAA grade at all. Up until now, the credit rating agencies have relied solely on traditional risk indicators, all of which are either borrower-focused or collateral-focused.

It seems that both home owners and mortgage lenders alike could benefit from an independent, objective and standardized third-party verification step that verifies the quality and risk associated with these loans before they are sold on the secondary market or before they are finalized by a broker. Consumers and investors could also benefit by having the ability to review the record of particular lenders.

Do you believe that assigning such a pre-securitization rating based upon borrower information, adequacy of collateral and loan quality would help to prevent future crises in the mortgage market?

Answer. On March 13th, the President's Working Group on Financial Markets (PWG), which is chaired by the Secretary, released the comprehensive "Policy Statement on Market Developments." The PWG's statement was intended to help to restore market liquidity, market discipline, and investor confidence through recommendations to enhance disclosure/transparency, due diligence/independent analysis, valuation techniques, risk management practices, regulatory policies, and market infrastructure. There are recommendations for all stakeholders (all market participants and regulators) and for all links in the chain of the securitization process (mortgage brokers, originators, securitizers, financial institutions, credit rating agencies, investors, and state and federal regulators).

The PWG made several recommendations to improve the quality and disclosure of information about and analysis of mortgage loans underlying securitized products, including:

—All states should implement strong nationwide licensing standards for mortgage brokers;

—Federal and state regulators should strengthen and make consistent government oversight of entities that originate and fund mortgages and otherwise interface with customers in the mortgage origination process;

—The Federal Reserve should issue stronger consumer protection and disclosure rules;

—Overseers of institutional investors should require investors to obtain from sponsors and underwriters of securitized credits better information about the risk characteristics of such credits, including information about the underlying asset pools;

—Overseers should ensure that these investors develop an independent view of the risk characteristics of the instruments in their portfolios, rather than rely solely on credit ratings;

—The PWG will form a committee to develop best practices regarding disclosure to investors in securitized credits;

—Credit rating agencies (CRAs) should disclose the reviews they perform on originators of assets and should require underwriters to represent the level and scope of due diligence performed on the underlying assets;

—CRAs should publish sufficient information about the assumptions underlying their credit rating methodologies, so that users of credit ratings can understand how a particular credit rating was determined;

—CRAs should provide the information investors need to make informed decisions about risk, including measures of the uncertainty associated with ratings and of potential ratings volatility; and

—The PWG will form a group to develop recommendations for further steps that issuers, underwriters, CRAs, and policymakers could take to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment.

Question. What key ways is your Department proposing to employ to close the "tax gap?" You once stated in a Finance Committee hearing that this is not a pot of gold. How big is the gap and what will it cost to close it?

Answer. The estimated size of the tax gap is as follows. In 2001, the overall compliance rate was estimated at over 86 percent, after late payments and recoveries from IRS enforcement activities. The tax gap results from noncompliance, specifically the amount of tax that should be paid but is not paid. After enforcement efforts and late payments, this amount was approximately $290 billion.

The key ways in which the Treasury Department is proposing to reduce the tax gap were set forth in a comprehensive strategy to improve tax compliance released in September 2006. The strategy builds upon the demonstrated experience and current efforts of the Treasury Department and IRS to improve compliance. Four key principles guided the development of this strategy: both unintentional taxpayer er-

rors and intentional taxpayer evasion should be addressed; sources of non-compliance should be targeted with specificity; enforcement activities should be combined with a commitment to taxpayer service; and tax policy and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden. These principles underscore the Treasury Department's and IRS' comprehensive, integrated, multi-year strategy to improve tax compliance. Components of this strategy include: (1) legislative proposals to reduce opportunities for evasion; (2) a multi-year commitment to compliance research; (3) continued improvements in information technology; (4) improvements in IRS compliance activities; (5) enhancements of taxpayer service; (6) simplification of the tax law; and (7) coordination between the government and its partners and stakeholders.

More specifically, the Treasury Department's fiscal year 2009 Revenue Proposals include a number of legislative proposals intended to improve tax compliance with minimum taxpayer burden. The fiscal year 2009 President's budget does include a number of legislative proposals intended to improve tax compliance with minimum taxpayer imposition. These proposals could generate $36 billion over the next ten years. The Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties.

—*Expand information reporting*.—Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would: require information reporting on payments to corporations; require basis reporting on security sales; require information reporting on merchant payment card reimbursements; require a certified Taxpayer Identification Number (TIN) from contractors; require increased information reporting on certain government payments; increase information return penalties; and improve the foreign trust reporting penalty.

—*Improve compliance by businesses*.—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would: require electronic filing by certain large organizations; and implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes.

—*Strengthen tax administration*.—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would: expand IRS access to information in the National Directory of New Hires for tax administration purposes; permit disclosure of prison tax scams; make repeated willful failure to file a tax return a felony; facilitate tax compliance with local jurisdictions; extend statutes of limitations where state tax adjustments affect federal tax liability; and improve the investigative disclosure statute.

—*Expand penalties*.—Penalties play an important role in discouraging intentional non-compliance. A specific proposal to expand penalties would impose a penalty on failure to comply with electronic filing requirements.

In the fiscal year 2009 President's budget, the IRS has budgeted over $23 million to implement these proposals. The budget also includes other items relating to the tax gap: over $286 million to reduce the tax gap for large business, small business, and the self-employed sector, to increase compliance of domestic taxpayers with offshore activity, and to minimize revenue loss by increasing document matching efforts; and over $51 million to increase support for research to understand better the reasons for taxpayer non-compliance.

Question. If we simplified our tax code with, for example, a flat income tax, what effect would there be on revenue receipts and revenue collection?

Answer. Replacing the existing income tax with a flat income tax could raise, lower, or leave unchanged tax revenue, depending on such design features as the tax rate imposed by the flat tax. A standard objective of tax reform efforts is to broaden the tax base and reduce tax rates. Generally speaking, the broader the base, the lower tax rates can be and still raise the same revenue as the current tax system. So, for example, eliminating or minimizing special exclusions, exemptions, deductions, and credits allows setting lower tax rates without reducing revenue. Both a broad tax base and lower tax rates are desirable from a policy perspective because they reduce economic distortions caused by the tax system.

Question. Will you commit to working with us and with SEC in preventing U.S. manufacturing companies from purchasing "blood minerals" like coltan from exporters who are abusing and murdering innocent people?

Answer. The Administration shares Congressional concern regarding the conflict in the Democratic Republic of Congo, which has been marked by serious violations of human rights and international law. To address this threat to the foreign policy of the United States, the President declared a national emergency and issued E.O.

13413 (October 27, 2006) implementing sanctions directed at persons contributing to the widespread violence and atrocities in the Democratic Republic of the Congo, as called for by U.N. Security Council Resolutions 1596 of April 18, 2005, and 1649 of December 21, 2005. The E.O. blocks the assets of, and prohibits U.S. persons from engaging in transactions and dealings with, persons listed in the Annex to, or designated pursuant to, the E.O. The Annex to the E.O. listed seven persons, including the notorious international arms dealer Viktor Bout, and OFAC designated an additional seven companies and three individuals pursuant to the E.O. in March 2007. A number of the March 2007 designations specifically related to exploitation of the gold sector in support of armed militia activity. OFAC continues to investigate aggressively the operations and holdings of rogue actors operating in the Democratic Republic of Congo.

Question. Last year, Congress passed and the President signed legislation to give your Office of Foreign Assets Control the ability to levy larger civil and criminal penalties for those who violate sanctions against rogue nations. Have the stronger tools helped provide a greater deterrent for those who would be inclined to deal with countries on whom we have imposed sanctions?

Answer. We appreciate Congressional efforts in increasing the maximum civil penalties available to the Office of Foreign Assets Control and believe that the availability of such meaningful penalties will serve as a meaningful deterrent for those who might otherwise treat civil penalties as merely "the cost of doing business." Indeed, OFAC has conducted several outreach events specifically on this topic. While it is still too soon to assess the full impact of the legislation that was passed last year, we note that there has been significant interest from the media and the general public related to these enhanced penalties.

CONGO/COLTAN

Question. The Office of Foreign Assets Control (OFAC) administers and enforces economic and trade sanctions, based on U.S. foreign policy and national security goals against foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction.

While the issue of exploited natural resources in the Democratic Republic of Congo, or specifically the issue of coltan may not be an engagement of proliferation of weapons of mass destruction, these activities are some of the most brutal human rights abuses we see in our world today (human-trafficking, child labor, sexual abuse and rape). The product of many of these actions leads to the refined component of a mineral which then ends up in much of our high technology industry here—cell phones, DVD players, flat screen televisions, etc. What are the limitations of OFAC's capabilities to target these rogue actors in eastern Congo?

Answer. Within the framework of E.O. 13413 (October 27, 2006) and related U.N. Security Council Resolutions, the Treasury Department has the authority to designate rogue actors engaging in activities contributing to the violence and atrocities taking place in the Democratic Republic of the Congo. OFAC continues to aggressively investigate the operations and holdings of such rogue actors (including militia leaders and their financial enablers) operating in the Democratic Republic of Congo. Improved access to credible and reliable on-the-ground information pertaining to the business activities of these rogue actors is always vital to OFAC's ability to designate potential targets.

Question. Has OFAC looked into targeting these rogue actors before?

Answer. The Annex to the E.O. 13413 listed seven persons, including the notorious international arms dealer Viktor Bout, and OFAC designated an additional seven companies and three individuals pursuant to the E.O. in March 2007. A number of the March 2007 designations specifically related to exploitation of the gold sector in support of armed militia activity. OFAC continues to investigate aggressively the operations and holdings of rogue actors operating in the Democratic Republic of Congo.

Question. What assistance might OFAC need in this procedure?

Answer. As stated above, access to on-the-ground information pertaining to the business activities of these rogue actors is vital to OFAC's ability to designate potential targets. OFAC is working to enhance its access to this type of information. OFAC as a matter of policy does not comment publicly on its techniques and sources for gathering this type of information.

Question. In regards to the budget, what accountability measures are in place, specifically regarding Congo, to ensure material resources are not siphoned off by these rogue actors? If any, what is Department of Treasury doing to implement these measures?

Answer. Pursuant to E.O.13413 (October 27, 2006), OFAC continues to investigate aggressively the operations and holdings of rogue actors operating in the Democratic Republic of Congo; designated individuals and entities are deprived of access to the U.S. financial system and any transactions involving U.S. persons.

Question. As a former board member of the Nature Conservancy, I know that you have a great interest in natural resource conservation. Would you support protecting parts of the Congo so that its natural resources are not further exploited?

Answer. The Department of the Treasury strongly supporting ongoing efforts to strengthen natural resource management in the Democratic Republic of Congo (DRC), particularly the efforts of the World Bank to encourage reform of the forestry and mining sectors. Some important steps taken to date by the Congolese authorities include establishing a moratorium on new logging titles and the promulgation of new Mining and Forest Codes. Treasury sees these as strong building blocks for longer-term reform and important steps toward filling the legal vacuum with respect to the governance of the Congolese forest and mining sectors. However, the situation in the DRC is extremely challenging and much work remains, including developing appropriate regulatory frameworks and strong institutions to manage these sectors. Treasury will continue to urge the World Bank to work with the Congolese authorities on the issue of natural resource management.

Further, the United States is a founding member and financial supporter of the Congo Basin Forest Partnership (CBFP) which brings together governments, the private sector, civil society and development organizations to conserve the unique natural resources of the Congo Basin, fight illegal logging and poaching, and improve the livelihoods of the Basin's 100 million inhabitants. The Department of Treasury respectfully refers you to the State Department and USAID for additional information, as they are the lead U.S. government agencies with regard to our involvement in the CBFP.

SUBCOMMITTEE RECESS

Secretary PAULSON. We will, and I thank you very much for the way you have supported Treasury's budget. And thank you very much.

Senator DURBIN. Thanks, Mr. Secretary. This meeting of the Subcommittee on Financial Services and General Government will stand recessed.

[Whereupon, at 4 p.m., Wednesday, March 5, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

WEDNESDAY, MARCH 12, 2008

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 4:02 p.m., in room SD–138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senator Durbin.

THE JUDICIARY

STATEMENT OF HON. JULIA S. GIBBONS, JUDGE, U.S. COURT OF APPEALS, SIXTH CIRCUIT; CHAIR, BUDGET COMMITTEE OF THE JUDICIAL CONFERENCE

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. This is the second of the subcommittee's hearings, and today we are going to focus on the fiscal year 2009 budget for the Federal judiciary.

We will be hearing from two distinguished witnesses: Judge Julia Gibbons—welcome—and Director James Duff. Welcome as well. I am pleased that you are here speaking on behalf of our Federal judiciary.

I welcome my colleagues who will come as the meeting progresses.

In fiscal year 2008, despite the difficulty the subcommittee faced in attempting to adequately fund all the various agencies within our jurisdiction and remain within the President's overall spending level, we managed to provide the judiciary with a 4.5 percent increase overall. With the prior 3 fiscal year increases of 5 percent, all this has helped put the courts back on track after suffering significant cuts in fiscal year 2004.

With fiscal year 2008 funds, hirings for probation and pretrial services are increasing back to previous levels; non-capital panel attorney rates were increased from $94 an hour to $100, a modest increase; courts were provided additional funding to absorb the additional caseload expected with increased border enforcement; court security requirements were fully funded; and authority was clarified that the U.S. Marshals may assume responsibility from the Federal Protective Service (FPS) for perimeter security at several designated courthouses.

For fiscal year 2009, you are requesting a 7.6 percent increase overall for the judiciary above last year's levels. In addition, within the defender services account, you are requesting an increase in the non-capital panel attorney rate, which would boost hourly rates from $100 to $118 and then to $140 in fiscal year 2010. The subcommittee provided a 7.6 percent increase for defender services last year, and such large pay increases for these attorneys this year will likely be optimistic, given our anticipated funding constraints. It is why I hope that we will be able to at least provide a modest increase in the non-capital panel attorney rate.

Regarding court security, I look forward to being updated on the progress of the pilot program undertaken with the U.S. Marshals Service at designated courthouses. I will also be interested to learn how the judiciary is implementing the Court Security Improvement Act. And I will want to discuss with you the Justice Department's inspector general's report on the U.S. Marshals Service.

I will have questions about courthouse construction, the impact of increased border enforcement, your workload, offender reentry programs, General Services Administration (GSA) rent, and more. If we cannot cover all the questions in the hearing, we will send them to you for the record, and I am sure that you can get them back to us in a reasonable period of time.

Senator Brownback will be unable to attend today's hearing, but has asked that his statement be submitted for the record.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Good afternoon. I want to thank you, Chairman Durbin, for your leadership. I look forward to working together with you during this coming year as we make funding decisions and provide oversight for the Federal Judiciary as well as the other agencies within this subcommittee's jurisdiction.

I would like to thank Judge Gibbons and Mr. Duff for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2009 budget request and the key efforts that the Judiciary will be undertaking this year. The Judiciary has the critical role of interpreting our laws and I am interested in hearing your thoughts on the state of our Nation's courts.

Looking at the budget submission, I am pleased to see an increase in defender services which is extremely important in light of last night's Senate passage of the Second Chance Act. This bill reshapes the way we look at prisoner re-entry. It is comprised of grant programs targeted at States, local governments and non-profit, faith-based organizations. And unlike most grant programs, in order to receive future funding under this act, programs must show real progress in reducing the recidivism rate of the program participants. As you all know, the U.S. Sentencing Commission recently passed the Crack Cocaine Sentencing Amendment, and it took effect in November. This sentence reduction for crack cocaine offences is retroactively applicable, thus allowing thousands of Federal offenders to seek reductions in their sentences. I would hope that with the passage of the Second Chance Act that we will be able to get much-needed re-entry programs to the inmates who truly need these essential services.

I would like to mention my concerns about the overall slowdown in Federal judge confirmations. There are currently 45 vacancies—14 circuit court vacancies and 31 district court vacancies with 27 nominees awaiting confirmation. I understand the hardship this places on the Judiciary. There is bit of progress being made, however, because yesterday the Judiciary Committee reported out several district court judges for confirmation on the Senate floor and tomorrow a circuit court judge is on the agenda for the Judiciary Committee markup. I am hopeful that we will continue to make progress in confirming judges and reducing the strain on the Judiciary.

Judge Gibbons and Mr. Duff, I look forward to hearing your testimony this afternoon.

Thank you, Mr. Chairman.

Senator DURBIN. I also note that the subcommittee is in receipt of written testimony submitted by the Court of Appeals for the Federal Circuit, the Court of International Trade, Federal Judicial Center, and the U.S. Sentencing Commission, all of which will be submitted for the hearing record.

Judge Gibbons, I am going to allow you to begin. I thank you for being here today and look forward to putting your remarks in the record. Judge Gibbons.

JUDGE GIBBONS' OPENING STATEMENT

Judge GIBBONS. Thank you for the opportunity to be here.

Chairman Durbin, I appear as Chair of the Judicial Conference Committee on the Budget, and with me today, of course, is Jim Duff, who is the Director of the Administrative Office of the United States Courts.

We thank you, Mr. Chairman, for attending the Judicial Conference session yesterday and for your remarks there.

FISCAL YEAR 2008 FUNDING

Let me begin by thanking the subcommittee for making the judiciary a funding priority in the fiscal year 2008 appropriations cycle. The courts are in good financial shape for 2008. The funding you provided will allow us to finance continuing operations in the courts and to address workload needs.

We are particularly appreciative of the $25 million you provided in emergency funding to respond to workload associated with immigration enforcement initiatives.

We are also grateful for two provisions that were included in the omnibus bill: the increase in the non-capital hourly rate for panel attorneys that you have referred to and the pilot project in our court security program.

FISCAL YEAR 2009 BUDGET REQUEST

Turning to the 2009 budget request, the judiciary is requesting $6.7 billion, an increase of $475 million over the 2008 enacted level; 86 percent of the increase is for standard pay and non-pay inflationary adjustments and for adjustments to base, reflecting increases in space, information technology, defender services, and court security programs. We are not requesting any new staff in clerks and probation offices.

The remaining $68 million of our requested increase is primarily for program improvements in our information technology program and an enhancement in the defender services program that you already referred to, increasing the hourly rate for private panel attorneys. We are appreciative of the increase you provided this year but believe an additional increase is warranted.

Our budget request reflects our continuing efforts to contain costs. We are now more than 3 years into an intensive effort to reduce costs throughout the judiciary and our cost containment program is producing results.

We have achieved so far the most significant savings in our space and facilities program through an ongoing rent validation project in which our court staff identify errors in rent for GSA to correct

and give us rent credits. GSA has been very cooperative in this endeavor.

In the information technology area, we are consolidating the deployment of computer servers which generate savings from reduced maintenance and equipment replacement costs.

We are also containing personnel costs. At its September 2007 meeting, the Judicial Conference approved recommendations from a major court compensation study that will slow the growth in personnel costs. Containing costs is a top priority for us.

COURT SECURITY PILOT PROJECT

Let me talk briefly about the pilot project approved in the 2008 omnibus bill. During my testimony last year before you, I discussed the judiciary's concerns regarding the expense and quality of security provided the courts by the Federal Protective Service. Chairman Durbin, you responded quickly to our concerns and convened a meeting with Director Duff and the Directors of the Marshals Service and the FPS.

As a result of your personal interest and commitment to improve court security, the subcommittee's bill included a provision for a pilot project permitting the Marshals Service to assume perimeter security duties from FPS at seven courthouses that have been selected. The Dirksen Federal Courthouse in Chicago will be the first pilot site to move forward. The project will begin later this year and will be in effect for approximately 18 months. We will provide you an evaluation of the project.

IMPACT OF INCREASED IMMIGRATION ENFORCEMENT

An issue that has received significant attention from Congress and the administration in recent years is illegal immigration. Despite zero tolerance immigration enforcement initiatives like Operation Streamline, in recent years resource constraints in the justice enforcement system on the border have limited the number of immigration cases prosecuted. It now appears that additional resources are making their way to the border through the Department of Justice's emergency funding received in 2008 and potentially through the funding requested in the President's 2009 budget. We believe the courts' workload will increase from this infusion of resources. Although we are not requesting funding for new clerks or probation staff on the border or elsewhere, we are very grateful for your provision of $45 million over the last 2 years to address the immigration-related workload so that we can respond in the short term to any increased workload.

We do need additional judgeships on the Southwest border. The Judicial Conference has requested 10 more judgeships on the border, and we make a special plea for the subcommittee's support of the $110 million requested for GSA in the President's budget to fund fully a new Federal courthouse in San Diego. This is our top space priority.

PREPARED STATEMENTS

I would ask that my statement, along with the others you referred to, be placed in the record. And, of course, we are available for your questions.

[The statements follow:]

PREPARED STATEMENT OF HON. JULIA S. GIBBONS

INTRODUCTION

Chairman Durbin, Senator Brownback, and members of the Subcommittee, I am Judge Julia Gibbons of the Sixth Circuit Court of Appeals. Our court sits in Cincinnati, Ohio, and my resident chambers are in Memphis, Tennessee. As the Chair of the Judicial Conference Committee on the Budget, I come before you to testify on the Judiciary's appropriations requirements for fiscal year 2009. In doing so, I will apprise you of some of the challenges facing the Federal courts. This is my fourth appearance before an appropriations subcommittee on behalf of the Federal Judiciary and my second appearance before the Financial Services and General Government panel. Appearing with me today is James C. Duff, the Director of the Administrative Office of the United States Courts.

In addition to a discussion of our fiscal year 2009 request, my testimony will cover several policy issues that impact the Federal courts. I will also update you on the Judiciary's efforts to contain costs as well as discuss several information technology innovations that are examples of the Judiciary(s continual efforts to improve Federal court operations.

STATEMENTS FOR THE RECORD

Mr. Chairman, in addition to my statement and Director Duff's, I ask that the entire statements of the Federal Judicial Center, the Sentencing Commission, the Court of Appeals for the Federal Circuit, and the Court of International Trade be included in the hearing record.

FISCAL YEAR 2008 FUNDING

Mr. Chairman and Senator Brownback, let me begin today by thanking you and your colleagues for making the Judiciary a funding priority in the fiscal year 2008 appropriations cycle. The funding you provided, combined with greater than anticipated fee carryover balances and reduced requirements due to our cost containment initiatives, will allow us to finance continuing operations in the courts as well as to address workload needs. We are particularly appreciative of the $25 million you provided the Judiciary in emergency funding to respond to workload associated with immigration enforcement initiatives being implemented by the Department of Homeland Security and the Department of Justice. We are fully cognizant of the difficult funding choices you faced during conference on the omnibus bill and appreciate your willingness to support the needs of the Judiciary. We appreciated the opportunity to work with the Subcommittee to identify our highest priority funding needs when your allocation was significantly reduced during conference on a final bill.

We also are grateful for several provisions included in the omnibus bill, which we believe will improve Federal court operations. Two that are particularly important are the pilot project to assess the feasibility of transferring responsibility for perimeter security at several designated primary courthouses from the Federal Protective Service to the United States Marshals Service and the increase in the non-capital hourly rate paid to private panel attorneys who represent eligible defendants under the Criminal Justice Act. I will discuss the pilot project in more detail next and return to panel attorney rates later in my testimony.

COURT SECURITY

Mr. Chairman, during my testimony last year I conveyed to the Subcommittee the Judiciary's concerns regarding the expense and quality of security provided the courts by the Federal Protective Service (FPS). FPS provides, on a reimbursable basis, exterior perimeter security for Federal agencies, including at courthouses and multi-tenant court facilities. The Judiciary's FPS costs are paid from our Court Security appropriation and fiscal year 2009 billings are projected to be $72 million.

Last year I spoke of incidents of inoperable FPS-provided exterior cameras at courthouses and the absence of cameras altogether at key locations resulting in

"dead zones" with no camera surveillance, despite our paying FPS for the equipment. Security lapses such as these left courthouses with serious security vulnerabilities. Fortunately, to help ensure that the courts had adequate security, the United States Marshals Service (USMS) assumed responsibility for repairing or replacing FPS-provided perimeter cameras at a number of courthouses where it was apparent that FPS did not have the resources to do so. This resulted in the Judiciary's paying for the same services twice: once to FPS in its security charges, and also to the USMS in the funding we transferred to it for systems and equipment for interior and perimeter courthouse security. The Judicial Conference had become increasingly concerned about this issue and consequently, in March 2007, it endorsed a recommendation to expand the USMS's current mission to include perimeter security of court facilities nationwide where the Judiciary is the primary tenant.

Mr. Chairman, within a month after last year's hearing you convened a meeting with the Directors of the United States Marshals Service, Federal Protective Service, and the Administrative Office of the United States Courts to learn more about this issue. As a result of your personal interest and commitment to improve court security, the Senate version of the fiscal year 2008 Financial Services and General Government appropriations bill (H.R. 2829) included the provision approving a pilot project permitting the USMS to assume responsibility from FPS for perimeter security at several designated courthouses. And, as I just mentioned, the provision was included in the final conference agreement on the fiscal year 2008 omnibus appropriations bill thus allowing the Judiciary and the USMS to begin implementation of the pilot. Specifically, the pilot project involves the USMS monitoring the exterior of the courthouses with court security officers and assuming control of FPS monitoring equipment. The USMS, working with the Administrative Office of the U.S. Courts, selected seven courthouses for the pilot. I would note that the Everett McKinley Dirksen U.S. Courthouse in Chicago will be the first pilot site to move forward. The other six sites are: the Theodore Levin U.S. Courthouse, Detroit, Michigan; the Sandra Day O'Connor U.S. Courthouse, Phoenix, Arizona; the Evo A. DeConcini U.S. Courthouse, Tucson, Arizona; the Russell B. Long Federal Building/U.S. Courthouse, Baton Rouge, Louisiana; the Old Federal Building and Courthouse, Baton Rouge, Louisiana; and the Daniel Patrick Moynihan U.S. Courthouse, New York, New York.

The pilot project is anticipated to begin in the fourth quarter of fiscal year 2008 and will be in effect for approximately 18 months at which time an evaluation of the pilot will be provided to the Subcommittee. The annualized cost of the pilot is estimated to be $5 million, which will be offset by anticipated reductions in FPS billings. We appreciate your concern with the security of our courthouses, and we will provide the Subcommittee with updates as the pilot project gets underway.

Work of the United States Marshals Service

I would like to say a few words about the vitally important work of the United States Marshals Service. Inside the courthouse, judges, court staff, attorneys, jurors, defendants, litigants, and the public depend entirely on the USMS for their safety. Heightened security at courthouses due to high-threat trials and terrorism concerns have made the work of the USMS more difficult, and it has responded extremely well to those challenges. For judges like myself, the USMS also ensures our security outside of the courthouse, and it takes this charge seriously. In September 2007, the USMS established a new Threat Management Center that serves as the nerve center for responding to threats against the Judiciary. The Center provides vital data to U.S. Marshals nationwide on threats against judges and court personnel. The USMS also has overseen the installation of nearly all of the 1,600 intrusion detection systems in the homes of Federal judges in order to provide increased judicial security outside of courthouse facilities. This has been a 2-year effort and includes ongoing system monitoring by a security firm. All of us in the Federal court family are grateful to John F. Clark, Director of the U.S. Marshals Service, his staff, and the U.S. Marshals throughout the 94 judicial districts for their dedication and responsiveness to the security needs of the Federal Judiciary. The USMS operates within very tight resource levels, and we urge Congress to fund fully the USMS's fiscal year 2009 budget request to enable it to continue meeting its statutory mandate to protect the Federal Judiciary.

RETROACTIVITY OF CRACK COCAINE SENTENCING AMENDMENT

Mr. Chairman, I would like to discuss an issue that has received some attention in recent months: the changes to Federal sentencing guidelines for crack cocaine offenses approved by the United States Sentencing Commission. The Commission is a bipartisan, independent agency within the Judicial Branch that was established

by the Sentencing Reform Act of 1984 to develop national sentencing policy for the Federal courts. The Commission promulgates the sentencing guidelines that Federal trial court judges consult when sentencing defendants convicted of Federal crimes.

On May 1, 2007, the Commission submitted a package of amendments to the Federal sentencing guidelines that, in the absence of congressional action to the contrary, went into effect on November 1, 2007. Among the amendments was one that modified the Federal sentencing guidelines for crack cocaine offenses. The amendment reduced the base offense level, or starting point, for crack cocaine offenses under the guidelines downward by two offense levels. This amendment does not affect the statutory mandatory minimum penalties for crack cocaine offenses established by Congress. The Commission took this action to alleviate some of the longstanding problems associated with the penalty scheme for cocaine offenses, which requires 100 times more powder than crack cocaine to receive the same statutory mandatory minimum penalty commonly referred to as the (100-to-1 ratio.) As a result of the amendment, the average sentence for crack cocaine offenders sentenced on or after November 1, 2007 will be approximately 16 months less than those sentenced before that date.

The Commission is authorized by statute to decide whether amendments that reduce penalties should be given retroactive effect. In December 2007, the Commission voted unanimously to give retroactive effect to the amendment for crack cocaine offenses. Retroactivity of the amendment became effective on March 3, 2008.

Pursuant to statute, once the Commission has given an amendment retroactive effect, a defendant, the director of the Bureau of Prisons, or a court on its own may move to have a defendant's term of imprisonment reduced pursuant to the Commission's policy statement on retroactivity and the limits of the amendment. The Commission estimates that approximately 19,000 Federal offenders over a span of several years may be eligible to seek to have their terms of imprisonment reduced as a result of retroactivity. These individuals were sentenced throughout the country although a large number of potentially eligible offenders were sentenced in districts located within the Fourth Circuit (West Virginia, Virginia, Maryland, North Carolina, and South Carolina).

A Federal sentencing judge will make the final determination of whether an offender is eligible for a lower sentence and how much that sentence should be lowered. That determination will be based on many factors, including whether the offender's reduced sentence or release would pose a danger to public safety.

I will not discuss the merits of retroactivity since such policy decisions are outside the Budget Committee's area of responsibility; however, I will note that the Criminal Law Committee of the United States Judicial Conference supported the Commission's decision on retroactivity. The Criminal Law Committee and its staff at the Administrative Office of the United States Courts have been working closely with the Commission to give the courts sufficient time, resources, and guidance to prepare for and process these cases. It is this process that I would like to take a moment to discuss.

We anticipate there may be an initial surge of motions for reductions in sentence filed in the Federal courts. These filings will be handled by various district court components, including district judges, clerks offices, probation and pretrial services offices, and Federal defender offices. It is generally agreed that a large number of motions for a reduction in sentence will not involve court hearings and will be decided on written filings, so our workload associated with processing those cases should not be unduly burdensome. The cases that require hearings will require more court resources. At present, no extraordinary measures have been necessary to address the increased workload due to retroactivity, although additional resources will be available if needed for smaller districts that may be disproportionately impacted by the number of Federal offenders seeking a reduction in sentence based on retroactivity.

We believe retroactivity will have the greatest impact on our probation offices. The crack cocaine offenders who may be released after a Federal judge grants the motion for a reduction in sentence will require close probation supervision, drug testing, and possibly drug and other treatment services as do other Federal offenders leaving Federal prison. At this time, however, our fiscal year 2009 budget does not request additional staffing or other resources associated with retroactivity of the crack cocaine sentencing amendment. The Judiciary believes the additional workload associated with retroactivity can be absorbed within existing resource levels.

IMPACT OF INCREASED BORDER ENFORCEMENT

Another issue that has received significant attention from Congress and the administration is illegal immigration, so I would like to discuss the impact of increased

border and immigration enforcement initiatives on the work of the Federal courts. In recent years the administration has dedicated significant resources to address the issue of illegal immigration. The President's fiscal year 2009 budget includes $12 billion for the Department of Homeland Security (DHS) for border security and enforcement efforts, a 19 percent increase over fiscal year 2008, and a more than 150 percent increase since 2001. DHS has used the funding to increase the number of border patrol agents significantly, particularly on the Southwest border with Mexico. Since 2001, more than 5,000 additional border patrol agents have been hired with most of them placed along the southwest border. In fiscal year 2008, DHS received funding to hire an additional 3,000 border patrol agents, and the President's fiscal year 2009 budget includes funding for another 2,200 agents, bringing the total to 20,000 agents. When fully staffed the Border Patrol will have more than doubled in size since 2001.

The level of criminal case filings in the Federal courts in the five judicial districts along the southwest border is high by historical standards—19,825 filings in 2007 versus 17,184 in 2001—but filings have not increased commensurate with the increased resources provided to DHS for border enforcement. Despite zero tolerance border initiatives such as Operation Streamline in which nearly everyone apprehended for violating U.S. immigration laws is prosecuted, resource constraints in the justice system have precluded more cases from being prosecuted in the Federal courts. Staffing shortages in U.S. Attorney offices, lack of detention beds needed to secure offenders awaiting prosecution, and staffing constraints in U.S. Marshals offices have resulted in the establishment of certain threshold levels in some border districts that must be met before a case is prosecuted. For example, a U.S. Attorney in one district may prosecute someone coming into the country illegally after the tenth attempt, while a U.S. Attorney in another district may prosecute after the fifth attempt.

To the extent the Federal courts are perceived as a factor that limits the number of cases that can be prosecuted on the border, I would note it is Congress that establishes the number of district judgeships and the districts to which they are assigned, and Congress and the Executive Branch that control the authorization, funding, and construction of new courthouses. The district courts on the southwest border have not received any new district judgeships since 2002 despite Judicial Conference requests for additional judgeships in 2003 (11 judgeships), 2005 (11 judgeships), and 2007 (10 judgeships). In recent years Congress has been responsive to the need for new courthouse space on the southwest border, and we hope that you will support the additional $110 million included in the President's fiscal year 2009 budget to fund fully a new Federal courthouse in San Diego, California. The Judicial Conference designated the San Diego courthouse a judicial space emergency in 2003, but the General Services administration has been unable to award a contract for the project due to escalating construction costs in Southern California.

It now appears that Congress has taken steps to address the resource needs across the justice system on the southwest border by providing additional resources beyond those provided to DHS. In fiscal year 2008 the Department of Justice received $7 million in emergency funding to hire more assistant U.S. Attorneys (AUSAs) in the five judicial districts along the southwest border. The U.S. Marshals Service received $15 million in emergency funding to address southwest border workload needs including the hiring of 100 additional deputy U.S. Marshals. The President's fiscal year 2009 budget includes $100 million for a new Southwest Border Enforcement Initiative focusing law enforcement and prosecutorial efforts on fighting violent crime, gun smuggling, and drug trafficking in that region. If funded, this initiative will increase the number of AUSAs along the southwest border by another 50 positions. The President's budget also seeks $88 million to expand detention capacity along the southwest border. The resultant increase in criminal filings we expect to see from this infusion of resources will impact our district judges, clerks offices, probation and pretrial services offices, and Federal defender offices on the border. I would note, however, that the Judiciary's fiscal year 2009 budget submission does not request funding for new clerks or probation office staff on the border or elsewhere. Congress provided the Judiciary with $45.4 million over the last 2 years—$20.4 million in fiscal year 2007 and $25 million in fiscal year 2008—to address immigration-related workload so, from a staffing perspective, the courts are well positioned in the short term to respond to the increased workload that we expect will materialize. However, as I just mentioned, we do require additional district judgeships on the southwest border, and construction of a new Federal courthouse in San Diego is the Judiciary's top space priority.

COST CONTAINMENT EFFORTS

The Judiciary recognizes that continuing pressures on the Federal budget due to the conflicts in Iraq and Afghanistan, investments being made to improve security here at home, and the goal of eliminating the budget deficit by 2012, will necessitate austere Federal spending going forward, particularly for non-security discretionary programs. Indeed, the President's fiscal year 2009 budget proposes a 0.3 percent increase in this category of spending, well below the rate of inflation. The administration and Congress are rightfully concerned about overall Federal spending and budget deficits, and we recognize that you face tough choices. I want to assure the Subcommittee that the Judiciary is doing its part to contain costs.

We are now more than 3 years into an intensive effort to reduce costs throughout the Judiciary. As I mentioned in my testimony last year, this cost containment effort was born out of our fiscal year 2004 experience in which a funding shortfall necessitated staff reductions of 1,350 clerk and probation office employees, equal to 6 percent of the courts' on-board workforce. As a result of this situation and the prospect of continuing Federal budget pressures, the late Chief Justice William H. Rehnquist charged the Judicial Conference's Executive Committee with developing an integrated strategy for controlling costs. After a rigorous 6-month review by the Judicial Conference's various program committees, the Executive Committee prepared, and the Judicial Conference endorsed in September 2004, a cost-containment strategy for the Federal Judiciary. The strategy focuses on the primary cost drivers of the Judiciary's budget—compensation costs and the rent we pay to the General Services Administration for courthouses and leased office space. We have had great cooperation Judiciary-wide as we have moved forward on implementing cost containment initiatives. I will highlight several cost containment initiatives for you.

Containing Rent Costs

The amount of rent we pay to GSA has been a matter of concern to the Judiciary for a number of years. Since fiscal year 2004 we have made a concerted effort to contain rent costs, with considerable success. In fiscal year 2004, prior to the implementation of cost containment, we projected that our GSA rent bill would be $1.2 billion in fiscal year 2009. I am pleased to report that our current GSA rent estimate for fiscal year 2009 is now projected to be $200 million less, or $1 billion, 17 percent below the pre-cost containment projection. Following are two of our rent containment initiatives that have contributed to these reduced rent costs.

—*Rent Validation Project*.—In recent years we have been working cooperatively with GSA to reduce our space rent costs through a rent validation program that has yielded significant savings and cost avoidances. This rent validation initiative originated in our New York courts where staff spent months scrutinizing GSA rent bills and found rent overcharges. The cumulative effect of this discovery were savings and cost avoidances over 3 fiscal years totaling $30 million. The Administrative Office expanded this effort nationwide by training all circuit executive offices to analyze and detect errors in GSA rent billings. Although it is quite time consuming, detailed reviews of GSA rent billings are now a standard business practice throughout the courts. Through this national effort, in fiscal year 2007 we identified additional overcharges totaling $22.5 million in multi-year savings and cost avoidances, bringing cumulative savings/cost avoidances to $52.5 million. We anticipate receiving additional rent adjustments and credits resulting from over $10 million in rent errors that we recently reported to GSA. By identifying and correcting space rent overcharges we have been able to re-direct these savings to other Judiciary requirements, thereby reducing our request for appropriated funds.

—*Rent Caps*.—To contain costs further, the Judiciary established budget caps in selected program areas in the form of maximum percentage increases for annual program growth. For our space and facilities program, the Judicial Conference approved a cap of 4.9 percent on the average annual rate of growth for GSA rent requirements for fiscal years 2009 through 2016. By comparison, the increase in GSA rent in our fiscal year 2005 budget request was 6.6 percent. This cap will produce a GSA rent cost avoidance by limiting the annual amount of funding available for space rental costs. Under this initiative, circuit judicial councils around the country will be responsible for managing rent costs in their circuits, which will require the councils to prioritize space needs—and in some instances deny requests for new space—in order to stay within the 4.9 percent cap.

Containing Information Technology Costs

Another cost containment success has been identifying and implementing more cost-effective approaches in deploying computer servers around the country. Before

this initiative, each court unit maintained local servers to access Judiciary applications and databases. New technology, along with improvements in the Judiciary's national data communications network, has allowed the consolidation of servers at a single location without compromising the performance levels of existing applications. In some cases performance has actually improved. As a result of this initiative, the Judiciary reduced by 89 the number of servers needed to run the jury management program, producing savings of $2 million in the first year and expected savings of $4.8 million through fiscal year 2012. In addition, servers that run the case management system in our probation program were consolidated, with projected savings and cost avoidances of $2.6 million through fiscal year 2012. The Judiciary expects expanded implementation of this initiative to result in significant information technology cost savings or cost avoidances. A big cost saver will be the consolidation of servers for the Judiciary's national accounting system in fiscal year 2008, which is expected to achieve savings and cost avoidances totaling $55.4 million through fiscal year 2012.

Containing Personnel Costs

A major focus of the Judiciary's cost containment efforts involves controlling personnel costs. At its September 2007 meeting, the Judicial Conference approved recommendations from a major court compensation study which will slow the growth in personnel costs throughout the Judiciary, specifically in clerks and probation offices and judges' chambers staff. The approved actions will reduce funding available to the courts for annual salary step increases for employees, limit the number of career law clerks (who are typically paid more than term law clerks), revise salary setting policies for new law clerks, and modernize the Federal courts' position benchmarks which govern the classification and grading of staff nationwide. We estimate these measures may save up to $300 million from fiscal year 2009 through fiscal year 2017.

INNOVATION IN THE FEDERAL COURTS

While we look to contain costs wherever possible, we continue to make investments in technologies that improve Federal court operations, enhance public safety, and increase public access to the courts to name just a few examples. The Judiciary is a leader in taking state-of-the-art technology and adapting it to the courts' unique needs, and we continually look for innovative ways to apply new technologies to our operations. These investments are made possible through the funding we receive from Congress, and we are grateful for Congress's continuing support of our information technology program. Let me describe for you several of our innovations.

Use of Global Positioning System Technology

Some of our probation and pretrial services offices are now using Global Positioning System (GPS) technology to monitor around the clock the location of individuals under pretrial release or post-conviction supervision. As a condition of their sentence or supervised release, an offender or defendant might be required to carry a GPS unit. Some GPS tracking devices let officers send a text message or voice message directly to the receiver worn by the offender enabling an alert to be sent if the offender wanders into forbidden territory.

An incident that occurred in California offers an example of the application of GPS technology. A defendant on a GPS tracking device was ordered by a Federal judge to stay away from his ex-wife due to a prior history of domestic violence. He was also subject to an active restraining order. In the middle of the day, the defendant drove by his ex-wife's place of employment. The pretrial services officer received a text message alert and immediately contacted the defendant on the tracking device, instructing him to come to the office. The officer contacted the ex-wife, the court was notified, and appropriate action was taken. In this instance, the pretrial services officer had established exclusion zones around the wife's home and work. For convicted sex offenders whose victims included children, these exclusion zones can include schools, parks, and playgrounds. Many offenders help defray the cost of monitoring on an ability-to-pay basis. GPS monitoring can cost up to $9 per day, roughly double the cost of less expensive electronic monitoring, but still well below the more than $63 per day required to incarcerate an offender.

Case Management/Electronic Case Files System

The Case Management/Electronic Case Files (CM/ECF) system is an electronic case management system that provides Federal courts with docket management capabilities, including the option of permitting case documents to be filed with the court over the Internet. Managing case filings electronically is more cost efficient than the labor-and-space intensive process of paper filings previously used. The elec-

tronic case filing system was launched in November 1995, when a team from the Administrative Office of the United States Courts helped the U.S. District Court in the Northern District of Ohio cope with more than 5,000 document-intensive asbestos cases. The court faced up to 10,000 new pleadings a week, a workload that quickly became unmanageable. The team developed a system that allowed attorneys to file and retrieve documents and receive official notices electronically. More than 10 years and several upgrades later, the system has fundamentally changed how the entire judicial system operates. The system is currently operating in all of our district and bankruptcy courts and will be operational in all of the regional courts of appeals in early 2009. Over 30 million cases are on CM/ECF systems nationwide, and nearly 350,000 attorneys and others have filed documents over the Internet. On average, four million new electronic documents are filed into the system each month, and roughly half of those are filed over the Internet by attorneys. CM/ECF is considered the world's most comprehensive court electronic case filing system. It has been one of the most important innovations in U.S. Federal court administration.

Public Access to Court Electronic Records

The Public Access to Court Electronic Records (PACER) system is an electronic access service run by the Federal Judiciary that allows the public to obtain case and docket information from Federal appellate, district, and bankruptcy courts via the Internet. The PACER system offers an inexpensive, fast, and comprehensive case information service to any individual with a computer and Internet access. Users can retrieve, among other information, a listing of parties and participants in a case, a compilation of case-related information, such as cause of action, nature of suit and dollar demands, judgments or case status, and appellate court opinions. The data is displayed directly on the user's computer screen within a few seconds. The system is available 24 hours a day and is simple enough that little user training is required. The PACER program has been hugely successful. In 2007 alone, over 350 million requests for information were processed by PACER. As directed by Congress, nominal fees are charged for accessing court records although some records are available without charge. Given the high-volume usage of PACER, the fees collected in the aggregate are substantial. Congress has authorized the Judiciary to utilize these fees to run the PACER program as well as to offset some costs in our information technology program that would otherwise have to be funded with appropriated funds. The Judiciary's fiscal year 2009 budget request assumes $68 million in PACER fees will be available to finance information technology requirements in the courts' Salaries and Expenses account, thereby reducing our need for appropriated funds.

THE JUDICIARY'S WORKLOAD [1]

I turn now to a discussion of the workload facing the courts. As indicated in the caseload table in our fiscal year 2009 budget request, 2008 caseload projections are used to compute fiscal year 2009 staffing needs. Our projections indicate that caseload will increase slightly in probation (+1 percent) and pretrial services (+3 percent) and increase substantially for bankruptcy filings (+23 percent). For 2008 we are projecting small declines in appellate (−3 percent) and criminal (−3 percent) caseload, and a steeper decline in civil filings (−8 percent). Let me discuss some recent trends and caseload drivers and offer some context for these projections.

Probation and Pretrial Services [1]

Workload in our probation and pretrial services programs continues to grow. The number of convicted offenders under the supervision of Federal probation officers hit a record 115,930 in 2007 and is expected to increase again in 2008 to 116,900. In addition to the increased workload, the work of probation officers has become significantly more challenging. In 1985, fewer than half of the offenders under supervision had served time in prison. By 2007, the percentage had climbed to 80 percent. As these figures indicate, probation officers no longer deal primarily with individuals sentenced to probation in lieu of prison. Offenders coming out of prison on supervised release have greater financial, employment, and family problems than when they committed their crimes. In addition, the number of offenders sentenced in Federal court with prior criminal convictions more than doubled between fiscal years 1996 and 2006, and the severity of the criminal histories of persons under probation officer supervision has been increasing as well. Offenders re-entering the community after serving time in prison require close supervision by a probation offi-

[1] Unless otherwise stated, caseload figures reflect the 12-month period ending in June of the year cited (i.e., 2008 workload reflects the 12-month period from July 1, 2007 to June 30, 2008).

cer to ensure they secure appropriate housing and employment. Successful re-entry improves the likelihood that offenders will pay fines and restitution and become taxpaying citizens.

Recent legislation will also increase the workload of probation and pretrial services officers. For example, we expect that the Adam Walsh Child Protection and Safety Act of 2006 will significantly increase the number of sex offenders coming into the Federal court system. The Adam Walsh Act also increases the registration requirements for sex offenders, which means probation officers must coordinate closely with State and local authorities to ensure that law enforcement and the public receive the required notice. Monitoring the behavior of sex offenders is challenging and requires intense supervision on the part of probation and pretrial services officers to protect the community.

As I discussed earlier in my testimony, the retroactive application of the crack cocaine sentencing amendment will also have an impact on the work of probation officers although it is difficult to predict with certainty at this point how many current Federal prison inmates will gain early release and enter the Federal probation system.

Bankruptcy Filings

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), implemented in October 2005, has significantly affected workload trends in the Nation's bankruptcy courts. While filings are still below pre-BAPCPA levels—751,056 filings in 2007 versus 1,635,725 filings in 2004—we forecast that filings will increase 23 percent in 2008 to 923,000 and top one million filings in 2009. The state of the economy, particularly as it impacts home foreclosures and credit availability, will be a major factor in the number of personal bankruptcies—which constitute the majority of bankruptcy cases. It is possible that 2008 bankruptcy filings will be above the current projection.

The number of filings alone, however, should not be viewed as the sole indicator of overall workload. BAPCPA created new docketing, noticing, and hearing requirements that make addressing the petitions far more complex and time-consuming. Our bankruptcy courts have indicated that the actual per-case work required of the bankruptcy courts has increased significantly under the new law, at least partially offsetting the impact on the bankruptcy courts of lower filings. For example, BAPCPA requires Chapter 7 filers to complete and pass a complex "means test" and receive a credit counseling briefing by an approved agency. Also, filers under Chapters 7 and 13 may not receive a discharge of their debts unless they have completed an approved financial management course. These and other new requirements must be reviewed by the clerk's office, which must take further action if the filers do not meet the requirements. BAPCPA also requires more than 35 new motions and pleadings in various chapters of the bankruptcy code. Each new motion requires judicial review and can result in hearings, orders, and opinions, thus consuming more judicial resources.

Appellate Filings

After hitting an all-time high of 68,313 filings in 2006, appellate caseload declined to 58,809 filings in 2007 and is expected to decline by 3 percent to 57,300 filings in 2008. This decline comes on the heels of significant workload growth from 2002 to 2006 during which filings increased 20 percent initially due to a surge in challenges to Board of Immigration Appeals (BIA) decisions in the appellate courts and later due to the large number of criminal and habeas corpus petitions filed by State and Federal prisoners from 2004 to 2006 challenging their sentences pursuant to the Supreme Court's decisions in *Blakely* v. *Washington* (2004), and in the consolidated cases, *United States* v. *Booker* and *United States* v. *Fanfan* (2005). After the initial surge of sentence-related filings associated with these decisions, we are now seeing appellate filings for criminal and habeas corpus petitions approach pre-*Blakely* and *Booker/Fanfan* levels.

About one-third of all BIA decisions are challenged in the Federal appellate courts with 70 percent of those challenges occurring in the Second and Ninth Circuits. While BIA appeals have dropped in the last year, these cases continue to demand extensive resources since they often turn on a credibility determination by a Department of Justice immigration judge, thus requiring close judicial review of a factual record by the appellate courts.

Civil Filings

Civil filings in the courts generally follow a more up and down filing pattern. In 2005 civil filings reached a record 282,758 filings, declined to 244,343 filings in 2006, then increased again to 272,067 filings in 2007. The increase in 2007 was due primarily to asbestos diversity case filings in the Eastern District of Pennsylvania.

The Judiciary projects civil case filings will continue this up and down pattern, decreasing 8 percent to 250,500 filings in 2008.

Criminal Filings

Criminal filings in the Federal courts have been trending downward the last several years, and this trend is expected to continue through 2008. From the previous year, filings declined 2 percent in 2005, 3 percent in 2006, and a half-percent in 2007 to 67,503 filings. Filings are projected to decline another 3 percent in 2008 to 65,800 filings.

Last year I testified that criminal filings were likely depressed due to significant vacancies in AUSA positions nationwide and that once vacancies were filled criminal filings would reverse course and begin to increase. As I mentioned earlier in my testimony, it now appears that additional resources are being provided to fill AUSA positions, particularly in the five judicial districts along the Southwest border with Mexico. Also, the administration is committing more resources to the prosecution of sexual exploitation of children. In fiscal year 2008, the Department of Justice received $5 million to hire 40 additional AUSAs to prosecute these exploitation cases under the Adam Walsh Act. I would emphasize that our criminal caseload projection for 2008 does not take into account the impact additional AUSAs will have on criminal case filings, so we may see 2008 filings above the projected level.

FISCAL YEAR 2009 BUDGET REQUEST

For fiscal year 2009, the Judiciary is seeking a 7.6 percent overall increase above the fiscal year 2008 enacted appropriations. The courts' Salaries and Expenses account, which funds clerks and probation offices nationwide, requires a 7.4 percent increase. Fiscal year 2009 appropriations requirements for each Judiciary account are included at Appendix A.

The goal of our fiscal year 2009 request is to maintain staffing levels in the courts at the level Congress funded in fiscal year 2008, as well as to obtain funding for several much needed program enhancements. As I noted earlier in my testimony, we are not requesting additional staff for our clerks or probation offices. We believe the requested funding level represents the minimum amount required to meet our constitutional and statutory responsibilities. While this may appear high in relation to the overall budget request submitted by the administration, I would note that the Judiciary does not have the flexibility to eliminate or cut programs to achieve budget savings as the Executive Branch does. The Judiciary's funding requirements essentially reflect basic operating costs of which more than 80 percent are for personnel and space requirements.

Eighty-six percent ($407 million) of the $475 million increase being requested for fiscal year 2009 funds the following base adjustments, which represent items for which little to no flexibility exists:

—Standard pay and benefit increases for judges and staff. This does not pay for any new judges or staff but rather covers the annual pay adjustment and benefit increases (e.g., COLAs, health benefits, etc.) for currently funded Judiciary employees. The amount budgeted for the cost-of-living adjustment is 2.9 percent for 2009.

—An anticipated increase in the number of on-board senior Article III judges.

—The projected loss in non-appropriated sources of funding due to the decline in carryover balances available in fiscal year 2009 versus the level available to finance the fiscal year 2008 financial plan (see discussion on the following page).

—Space rental increases, including inflationary adjustments and new space delivery, court security costs associated with new space, and an increase in Federal Protective Service charges for court facilities.

—Adjustments required to support, maintain, and continue the development of the Judiciary's information technology program which, in recent years, has allowed the courts to "do more with less"—absorbing workload increases while downsizing staff.

—Mandatory increases in contributions to the Judiciary trust funds that finance benefit payments to retired bankruptcy, magistrate, and Court of Federal Claims judges, and spouses and dependent children of deceased judicial officers.

—Inflationary increases for non-salary operating costs such as supplies, travel, and contracts.

—Costs associated with Criminal Justice Act (CJA) representations. The Sixth Amendment to the Constitution guarantees that all criminal defendants have the right to the effective assistance of counsel. The CJA provides that the Federal courts shall appoint counsel for those persons who are financially unable to pay for their defense.

After funding these adjustments to base, the remaining $68 million requested is for program enhancements. Of this amount:

—$33 million will provide for investments in new information technology projects and upgrades, and courtroom technology improvements.

—$18 million to increase the non-capital panel attorney rate from $100 to $118 per hour. I will discuss this requested increase in more detail in a moment.

—$8 million is requested for the Supreme Court's exterior renovations and roof system repairs.

—$5 million is for additional staff and associated costs to address fiscal year 2009 workload requirements (32 FTE), two additional magistrate judges and staff (9 FTE), library renovations and new equipment at the Court of Appeals for the Federal Circuit, and the start-up costs for two new Federal defender organizations.

—$4 million would provide for necessary investments in court security, such as court security systems and equipment and new positions at the United States Marshals Service (9 FTE).

Non-Appropriated Sources of Funding

I would like to discuss briefly the non-appropriated sources of funding that the Judiciary uses to partially finance its operations and how they impact our appropriations needs. In addition to appropriations from Congress, the Judiciary collects fees from bankruptcy and civil case filings, from the public for on-line access to court records, and from other sources. Fees not utilized during the year they are collected may be carried over to the next fiscal year to offset appropriations requirements in that year. Every fee dollar collected that is not needed to finance current year needs represents a dollar less that the Judiciary must seek from Congress in the following year.

In formulating the Judiciary's fiscal year 2009 budget request, we made certain assumptions regarding the level of fees and carryover that would be available to finance fiscal year 2009 requirements. Because the projection for carryover balances are below the level that was available to finance fiscal year 2008 operations, the fiscal year 2009 request includes a line item requesting appropriated funds—$95 million in the courts' Salaries and Expenses account—to replace the anticipated decline in carryover balances. (New fee collections are projected to be flat from fiscal year 2008 to fiscal year 2009 so there is no restoration requested or needed for that component of our financing.) While it is premature for me to identify a specific amount, I am confident that we will not need the full $95 million we requested to replace carryover balances. This is due to several factors, including the courts' frugal spending during the continuing resolution for the first quarter of fiscal year 2008 and fewer judge confirmations than we anticipated. As we did this past year, we will keep the Subcommittee apprised of changes to fee and carryforward projections that could impact our fiscal year 2009 appropriation needs as we move through fiscal year 2008. The Judiciary will submit the first of two fiscal year 2009 budget re-estimates to the Subcommittee in May 2008.

INCREASE IN NON-CAPITAL PANEL ATTORNEY RATE

We believe that one program enhancement in our budget request deserves strong consideration in order to ensure effective representation for criminal defendants who cannot afford to retain their own counsel. We are requesting $17.5 million to increase the non-capital panel attorney rate to $118 per hour, effective January 2009. A panel attorney is a private attorney who serves on a panel of attorneys maintained by the district or appellate court and is assigned by the court to represent financially-eligible defendants in Federal court in accordance with the Criminal Justice Act (CJA). In the fiscal year 2008 omnibus spending bill, the Subcommittee approved an increase in the non-capital rate paid to these panel attorneys from $94 to $100 per hour, and provided a cost-of-living adjustment to the capital rate from $166 to $170 per hour. These new rates took effect on January 1, 2008.

While we are very appreciative of the increase to $100 per hour for non-capital work, we believe a more significant increase is required to enable the courts to attract and retain enough qualified attorneys to accept appointments and to provide them a fair rate of pay. This is critical in order for the Judiciary to ensure that persons represented by panel attorneys are afforded their constitutionally guaranteed right to effective assistance of counsel.

We believe there is a direct relationship between the lack of qualified panel attorneys available to take CJA appointments and the significant financial difficulties panel attorneys encounter maintaining their legal practices at the current rate. It is predominantly solo and small-firm lawyers that take on CJA cases, and these panel attorneys must first cover their overhead costs. With overhead costs of ap-

proximately $64 per hour, at the $100 rate, that leaves a net average of only $36 per hour, before taxes. We believe that this net rate of $36 per hour, when compared to the net national average "market rate" of $148 per hour for non-CJA private criminal cases, prevents the courts from attracting sufficient numbers of qualified attorneys to take CJA appointments because those attorneys can obtain higher pay on non-CJA cases. Each time a panel attorney is asked by the court to accept a non-capital CJA appointment, he or she must consider the inherent "opportunity" cost associated with the higher hourly rate he or she could otherwise earn on a non-CJA case.

The CJA authorized the Judicial Conference to implement annual cost-of-living adjustments (COLAs) to panel attorney rates, subject to congressional funding. If the statutory COLAs provided to Federal employees (the base employment cost index component only) had been provided to panel attorneys on a recurring, annual basis since 1986, the authorized non-capital hourly rate for fiscal year 2009 would be $136. While the Judicial Conference supports the $136 rate, it is mindful of the constrained Federal budget environment and, therefore, proposes attaining the authorized rate in two stages, an $18 per hour increase in fiscal year 2009 from $100 to $118 per hour, with a second increase to $140 per hour in fiscal year 2010 (the $140 rate includes a $4 COLA to the fiscal year 2009 rate of $136). The Judiciary is committed to fully restoring the non-capital panel attorney rate, in a cost-conscious manner, by implementing the authorized rate over 2 years.

I will close on this topic by reiterating that the Judiciary greatly appreciates the $100 non-capital rate Congress provided in fiscal year 2008, but the concern remains that, after overhead is considered, the rate does not provide compensation that will attract enough qualified panel attorneys to take on the complex work involved in Federal criminal cases. I urge the Subcommittee to provide the funding necessary to increase the non-capital panel attorney rate to $118 per hour in fiscal year 2009.

CONTRIBUTIONS OF THE ADMINISTRATIVE OFFICE

I would like to briefly outline the important work performed by the Administrative Office (AO) of the United States Courts. Year in and year out, the AO provides critical support to the courts. With only a fraction (1.3 percent) of the resources that the courts have, the AO does a superb job of supporting our needs.

The AO has key responsibilities for judicial administration, policy implementation, program management, and oversight. It performs important administrative functions, but also provides a broad range of legal, financial, program management, and information technology services to the courts. None of these responsibilities has gone away and new ones are continually added, yet the AO staffing level has been essentially frozen for 15 years. As an example, despite no new staff, the AO has been instrumental in implementing the Judiciary's cost containment strategy which has achieved significant savings and cost avoidances.

In my role as Chair of the Judicial Conference Committee on the budget, I have the opportunity to work with many staff throughout the AO. They are dedicated, hard working, and care deeply about their role in supporting this country's system of justice.

The fiscal year 2009 budget request for the Administrative Office is $82 million. The AO's request represents a current services budget, no additional staff or program increases are sought. All of the requested increase is necessary to support current services, mainly standard pay and general inflationary increases, as well as funding to replace the anticipated lower level of carryover amounts with appropriated funds in fiscal year 2009.

I urge the Subcommittee to fund fully the Administrative Office's budget request. The increase in funding will ensure that the Administrative Office continues to provide program leadership and administrative support to the courts, and lead the efforts for them to operate more efficiently. Director Duff discusses the AO's role and budget request in more detail in his testimony.

CONTRIBUTIONS OF THE FEDERAL JUDICIAL CENTER

I also urge the Subcommittee to approve full funding for the Federal Judicial Center's request of $25.8 million for fiscal year 2009.

The Center's director, Judge Barbara Rothstein, has laid out in greater detail the Center's needs in her written statement. I simply add that the Center plays a vital role in providing research and education to the courts. The Center's research and its educational programs are highly respected and valued for their quality and objectivity. The Judicial Conference and its committees request and regularly rely on research projects by the Center. The Center's educational programs for judges and

court staff are vital in preparing new judges and court employees to do their jobs and in keeping them current so that they can better deal with changes in the law, and in tools—like technology—that courts rely on to do their work efficiently.

The Center has made good use of its limited budget. It uses several technologies to deliver information and education to more people more quickly and inexpensively. The relatively small investment you make in the Center each year (less than one-half of 1 percent of the Judiciary's budget) pays big dividends in terms of the effective, efficient fulfillment of the courts' mission.

CONCLUSION

Mr. Chairman, I hope that my testimony today provides you with some insight into the challenges facing the Federal courts as well as what we are doing to contain costs and become more efficient. I realize that fiscal year 2009 is going to be another tight budget year as increased mandatory and security-related spending will result in further constrained domestic discretionary spending. We recognize the fiscal constraints Congress is facing. Through our cost-containment efforts and information technology innovations we have significantly reduced the Judiciary's appropriations requirements without adversely impacting the administration of justice. I know you agree that a strong, independent Judiciary is critical to our Nation. I urge you to fund this request fully in order to enable us to maintain the high standards of the U.S. Judiciary.

Thank you for your continued support of the Federal Judiciary. I would be happy to answer any questions the Subcommittee may have.

APPENDIX A.—JUDICIARY APPROPRIATIONS

[Dollars in thousands]

Appropriation account	Fiscal year 2008 enacted level (Public Law 110–161) [1]	Fiscal year 2009 President's budget (Feb. 4, 2008)	Percentage change: fiscal year 2009 vs. fiscal year 2008 enacted
U.S. Supreme Court:			
Salaries & Expenses	$66,526	$69,777	+4.9
Care of Building and Grounds	12,201	18,447	+51.2
Total	78,727	88,224	+12.1
U.S. Court of Appeals for the Federal Circuit	27,072	32,357	+19.5
U.S. Court of International Trade	16,632	19,622	+18.0
Courts of Appeals, District Courts & Other Judicial Services:			
Salaries & Expenses:[1]			
Direct	4,619,262	4,963,091	+7.4
Vaccine Injury Trust Fund	4,099	4,253	+3.8
Total	4,623,361	4,967,344	+7.4
Defender Services [1]	846,101	911,408	+7.7
Fees of Jurors & Commissioners	63,081	62,206	−1.4
Court Security	410,000	439,915	+7.3
Subtotal	5,942,543	6,380,873	+7.4
Administrative Office of the United States Courts	76,036	81,959	+7.8
Federal Judicial Center	24,187	25,759	+6.5
Judiciary Retirement Funds	65,400	76,140	+16.4
U.S. Sentencing Commission	15,477	16,257	+5.0
Direct	6,241,975	6,716,938	+7.6
Vaccine Injury Trust Fund	4,099	4,253	+3.8
Total	6,246,074	6,721,191	+7.6

[1] Pursuant to Public Law 110–161, fiscal year 2008 appropriations include $25 million in emergency appropriations ($14.5 million in the courts' Salaries and Expenses account and $10.5 million in the Defender Services account) for workload associated with DOJ and DHS immigration enforcement initiatives.

PREPARED STATEMENT OF PAUL R. MICHEL, CHIEF JUDGE, UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

Mr. Chairman, thank you for allowing me to submit my statement supporting the United States Court of Appeals for the Federal Circuit's fiscal year 2009 budget request.

Our request totals $32,357,000, an increase of $5,285,000 (19.5 percent) over the fiscal year 2008 appropriation of $27,072,000. The primary justification for such an unusual increase is the need to accommodate seven senior judges who will expand our court's judicial output in 2009.

Thirty percent of this requested increase ($1,575,000) is for Congressionally and contractually mandated adjustments to base (such as COLAs and escalation in rent and contracts). The only addition included in the adjustment to the base appropriation is $298,000 to lease chambers outside the courthouse for senior judges for whom there is no space in the courthouse.

Four Federal Circuit judges are eligible to take senior status now; three more will become eligible in fiscal year 2009; and another judge will become eligible in fiscal year 2010. Of the three Federal Circuit judges who will become eligible to take senior status in fiscal year 2009, at least two are expected to do so. An increase to the Court's base of $298,000 will cover the cost of an off-site lease for these two judges and up to three of the other four senior judges who are eligible for senior status.

Seventy percent of the Federal Circuit's fiscal year 2009 budget request, $3,710,000, is to fund three specific program requests.

—The first specific program request ($1,860,000) is to build out off-site chambers for five senior judges.

—The second specific program request ($932,000) is for 12 law clerk positions for active judges, and

—The third specific program request ($918,000) is for court improvements and a court employee position.

PART 1

Half of the 70 percent increase for specific program requests ($1,860,000) will fund build out of leased chambers for five of the seven judges who either are, or will be, eligible to take senior status in fiscal year 2009. This amount is based on an estimate coordinated with the Administrative Office of the United States Courts and on personal experience with GSA in renovating chambers in this courthouse. This amount will provide the leased chambers with the furniture, furnishings and finishes consistent with the U.S. Courts Design Guide. The amount requested is the amount needed to support judges eligible and expected to take senior status now through fiscal year 2010 and for whom there is no room in the existing courthouse.

As noted, two of the seven judges who will be eligible to take senior status have indicated a desire to do so when they become eligible for senior status in fiscal year 2009. Personal circumstances make it likely that at least two more will also do so. It is imperative then that the Federal Circuit acquire suitably built-out, off-site leased chambers for the two judges who have indicated a desire to take senior status in fiscal year 2009, two or three of the four already eligible, and another who is likely to do so in fiscal year 2010.

PART 2

Twenty-five percent of the specific program requests ($932,000) will fund 12 additional law clerk positions. The Court is requesting $932,000 to cover the cost of hiring an additional law clerk for each of the court's active judges for 6 months of fiscal year 2009. The court's increased workload now justifies funding a fourth law clerk for each active judge. Four law clerks are the norm at every Federal Appeals Court in the Nation except the Federal Circuit. In our fiscal year 2008 appropriation, Congress authorized three additional law clerks but provided no funding. We are now requesting funding for all 12 additional law clerks: the three approved but unfunded in fiscal year 2008, and the remaining nine, for a total of 12, or one per judge.

Patent infringement cases make up one-third or more of the Federal Circuit docket. The number of patent infringement cases has grown by more than 25 percent in the 15 years since the third clerk was first provided. Patent infringement cases are critical to the Nation's economy, and the decisions of the Federal Circuit in these cases often have significant and sometimes dramatic economic implications for parties whose patents are upheld and found to have been infringed, whose patents are found not to have been infringed by other parties, and many other economic actors. The difficulty and complexity of patent infringement and other intellectual property cases have increased exponentially in recent years.

Most of the patent cases now filed in the Federal Circuit Court of Appeals are highly technical and require great insight and judgment. The issues presented in these cases involve arcane breakthroughs on the frontiers of science, technology, manufacturing, engineering, mathematics and medicine. In such cases legal judgments must be made, not only about the law itself but often on the basic underlying technical innovation, with few if any precedents, analogies or objective metrics to apply to help determine the outcome.

Many such cases involve a multitude of issues, no one of which can be ignored in an effort to narrow and focus the decision-making process as so often happens on appellate review. In patent infringement cases, all issues must typically be left together because together they frame the problem and the outcome. The practical effect is that one case takes on the nature of several, whose many issues must be understood individually and collectively before the court can integrate them into a unifying substantive decision.

Timeliness is also an issue in many of these cases because the speed of technological change can render a delayed decision essentially ineffectual in a rapidly-changing economic marketplace.

In the appeal of such cases the question is not only whether the law was correctly applied below, but also whether the science or technology was understood correctly by the trial judge or jury. The latter issue is especially important in the innovative appeals that come so often before this court, where there are few if any boundaries, signposts, or rules to guide the deciding judges. In many cases the court is required to engage in *de novo* review. This means the judges must review all elements of the decision below, in some cases retracing the actual footwork of the trial judge, if not actually embarking on entirely new lines of thought, logic and analysis.

In patent infringement and other intellectual property cases most judges and their law clerks have to master an unfamiliar field of science and draw the best conclusions they can from scarce and limited resources. Because judges are assigned to panels randomly and not by specific subject matter expertise, all judges and their law clerks on the Federal Circuit are required to engage in extensive, and fundamental scientific inquiries in every area of science and technology. The practical effect is that each judge with his or her Chambers staff is engaged simultaneously in varied and complicated exercises, as opposed to deciding a series of often less complex, single issue cases, as in other courts of appeals.

The Federal Circuit's need for additional law clerks is based on an increased caseload in highly technical and complex appeals. Having a fourth law clerk would ensure that the judges of the United States Court of Appeals for the Federal Circuit can give the Nation, practitioners and litigants and the Patent and Trademark Office timely and thoughtful deliberation on the many challenging, critical and complex issues that come before the Court.

PART 3

Approximately 25 percent of the specific program requests ($918,000) will fund the following:

—Cooling equipment for the network server room ($350,000);
—A new Internal Controls Analyst position ($71,000);
—Renovations to the Circuit Library ($200,000);
—Enhancements to courtroom computer technology ($255,000); and
—Furniture and equipment for the new positions requested ($42,000).

These items are important to the management and internal operation of the United States Court of Appeals of the Federal Circuit.

Permanent Cooling Equipment.—The Court requests $350,000 to provide permanent cooling equipment for the network server room. The Court's server room was jerry-built out of an internal office space. It was never properly configured, ventilated, wired or equipped. Following several instances of dangerously high temperatures, we took temporary steps to mitigate some of the immediate problems. These funds would enable us to reconfigure and cool the server room properly, thereby saving the life of expensive hardware and equipment and greatly improving the reliability of information technology for the court's judges and staff.

Internal Controls Analyst.—The Court is requesting $71,000 for a new Internal Controls Analyst position which was authorized and encouraged throughout the judiciary by the Judicial Conference. We have already assigned existing staff additional duties to conduct internal audits, inspections and inventories. But having a dedicated, trained professional to perform these responsibilities would fulfill the vision the Judicial Conference contemplates and materially improve the stewardship of the court's property, funds, and internal procedures.

Circuit Library Renovations.—The Court is requesting $200,000 to design and construct renovations to the Circuit Library, which has not been renovated since the courthouse was built in 1965. These modest renovations would improve access to and efficiency in managing the Library collection.

Courtroom Technology Enhancements.—The Court is requesting $255,000 to finance technological enhancements in our third courtroom, consistent with long-standing policy of the Judicial Conference. Such enhancements include digital sound recording equipment to enable uploading the audio portion of oral arguments on the court's website; laptop connectivity equipment and training to bring the courtroom into the 21st century and allow judges and their law clerks and counsel to use personal computers during arguments; under-floor cabling for safety, security and easy access; and video-conferencing infrastructure for remotely conducted oral arguments.

Furniture and Equipment.—The Court is requesting $42,000 for furniture and equipment for the new positions described above: 12 law clerks and an internal controls analyst.

Mr. Chairman, I would be pleased to answer any questions the Committee may have or to meet with the Committee members or staff about our budget request. Thank you.

PREPARED STATEMENT OF JANE A. RESTANI, CHIEF JUDGE, UNITED STATES COURT OF INTERNATIONAL TRADE

Mr. Chairman, Members of the Committee: I would like to once again thank you for providing me the opportunity to submit this statement on behalf of the United States Court of International Trade, which is established under Article III of the Constitution with exclusive nationwide jurisdiction over civil actions pertaining to matters arising out of the administration and enforcement of the customs and international trade laws of the United States.

The Court's budget request for fiscal year 2009 is $19,622,000. This represents an overall increase of $2,990,000 or 18 percent over the Court's fiscal year 2008 enacted appropriation of $16,632,000. The primary reason for this increase in the fiscal year 2009 budget request is a substantial increase in GSA rent charges. The total GSA rent estimate for fiscal year 2009 is $7,527,041, which is an increase of $2,336,000 over the fiscal year 2008 rent estimate. To put these charges in perspective, it is important to note that these fiscal year 2009 rent charges represent 78 percent of the Court's total requested increase and 38 percent of the Court's total requested budget. The rent rate increase reflects a 50 percent increase in the shell rate as a result of a new appraisal by GSA. While the shell rate is primarily responsible for the increase in GSA rent charges, those increase charges also include a new expenditure of $803,012 for the amortized cost of the Court's Congressionally-approved security pavilion. The process for the construction of this security pavilion began in fiscal year 2002 when Congress authorized $75,000 for an architectural analysis of the repairs and upgrades needed to ensure the health, security and effective operation of the Court. The results of this analysis eventually led to the construction of the security pavilion that will be completed toward the end of fiscal year 2008.

Despite the substantial increase in rent charges, which is outside of the Court's control, the Court continues, as it has done for the past 13 years, to budget conservatively and request only funds that will provide for mandatory increases in pay, benefits and other inflationary factors, as well as funds for the essential on-going operations and initiatives of the Court. These increases are in line and consistent with the Court's prior average budgetary requests of 4.8 percent. I note also that these modest increases include increases in costs paid to the Federal Protective Service for basic and building-specific security surcharges. The security surcharges provide for the Court's pro-rata share of installing, operating and maintaining systems for the critical and necessary security of the Federal Complex in lower Manhattan.

Through the use of its annual appropriation and the Judiciary Information Technology Fund (JITF), the Court continues to promote and implement the objectives set forth in its Long Range Plan. These objectives promote access to the Court through the effective and efficient delivery of services and information to litigants, the bar, public, judges and staff. As a national court, this access is critical in realizing the Court's mission to resolve disputes by (1) providing cost effective, courteous and timely service, (2) providing independent, consistent, fair and impartial interpretation and application of the customs and international trade laws and (3) fostering improvements in customs and international trade law and practice and improvement in the administration of justice.

The Court continues to aggressively implement its information technology and cyclical maintenance/replacement programs. In fiscal year 2007, the Court: (1) purchased, configured and tested three new replacement servers, two new file servers and one internet server; (2) tested the new 3.1 version of the Court's customized version of the Federal Judiciary's Case Management/Electronic Case Files (CM/ECF) System; (3) cyclically upgraded, replaced and supported desktop computers and printers throughout the Court; (4) upgraded the Court's photo-copiers with new digital copiers with scanning and faxing capabilities; (5) installed the new version of Word Perfect; (6) supported and maintained all technical equipment and software applications; and (7) utilized an Administrative Office contract for professional consulting services for an evaluation of the needs of the Court in the design and implementation of a new video conferencing system. Additionally, in fiscal year 2007, the Court continued its cyclical maintenance program by: (1) refurbishing the finance/property/procurement and the technical development support sections of the Clerk's Office; and (2) refurbishing two case file rooms and the confidential storage room for better space utilization.

In fiscal year 2008, the Court plans to expend funds to: (1) review and subsequently implement the consultant's recommendations, mentioned in the above, for the purchase of a new video conferencing system; (2) install the file and internet servers and replace the Court's voice, fax and domain name servers; (3) replace desktop computer systems and VPN laptops in accordance with the Judiciary's cyclical replacement program; (4) upgrade and support existing software applications; (5) purchase new software applications to ensure the continued operational efficiency of the Court; and (7) support Court equipment by the purchase of yearly maintenance agreements. The Court will also continue to expand its developmental and educational programs for staff in the areas of job-related skills and technology.

In fiscal year 2009, the Court will not only remain committed to using its carryforward balances in the Judiciary Information Technology Fund to continue its information technology initiatives and to support the Court's short-term and long-term information technology needs, but will also continue its commitment to its cyclical replacement and maintenance program for equipment and furniture for the Courthouse. This latter program not only ensures the integrity of equipment and furnishings, but maximizes the use and functionality of the internal space of the courthouse. Additionally, the fiscal year 2009 request includes funds for the support and maintenance of the Court's upgraded security systems. Lastly, the Court will continue its efforts to address the educational needs of the bar and Court staff.

As I have continually stated in previous years, the Court remains committed to maintaining its security systems to ensure the protection of those who work in and visit the Courthouse. The Court is looking forward to the completion of its security pavilion in the third quarter of fiscal year 2008. This pavilion is expected to be fully operational in fiscal year 2009. The Court has worked in partnership with GSA in the design, construction and completion of this entrance pavilion and is most gratified to see that everyone's efforts and hard work will finally be realized.

I would like to again emphasize that the Court will continue to conservatively manage its financial resources through sound fiscal, procurement and personnel practices. As a matter of internal operating principles, the Court routinely has engaged in cost containment strategies in keeping with the overall administrative policies and practices of the Judicial Conference. For over 5 years the Court has only requested funds to maintain current services. The extraordinary increase in the fiscal year 2009 projected rent charges has caused concerns regarding the Court's ability to maintain current services without additional funds to support the rent increase. In an effort to lessen the projected impact of this rent increase, at the end of fiscal year 2007 and continuing into fiscal year 2008, the Court began the initial review process of the fiscal year 2009 rent rate. Several meetings were held with high level regional GSA personnel responsible for the review and implementation of the rent pricing rates. Additionally, the Clerk of Court met with the Administrative Office. In order to proceed with the process and at the suggestion of the Administrative Office, the Court, in fiscal year 2008, will issue a work order for an independent appraisal analysis. Once the new appraisal is completed and reviewed, subsequent meetings will be held with GSA's high level regional and national office personnel in an effort to reduce the high rent increase.

Lastly, I would like to personally extend my deepest thanks and appreciation to Congress for recognizing the needs of the Court by providing, in fiscal years 2007 and 2008, adequate funding to maintain current services. I am confident that Congress, in fiscal year 2009, will provide the needed funds for the increase in rent costs, thereby enabling the Court to continue to operate in a cost effective and efficient manner.

The Court's "General Statement and Information" and "Justification of Changes," which provide more detailed descriptions of each line item adjustment, were submitted previously. If the Committee requires any additional information, we will be pleased to submit it.

PREPARED STATEMENT OF HON. BARBARA J. ROTHSTEIN, DIRECTOR, FEDERAL JUDICIAL CENTER

I am Barbara Rothstein. I have been the Center's director since 2003, and a district judge since 1980. I am pleased to submit the Center's 2009 budget request on behalf of the Center's Board, which the Chief Justice chairs, and which approved this request.

First, the Center is grateful for the efforts of Congress to provide in fiscal year 2008 not only full adjustments to its 2007 base (for only the second time in more than a decade) but also $156,000 for three new positions (30 percent of the $504,000 we sought in fiscal 2008 to restore 10 of the 22 Center positions vacated and frozen since 2003 because of budget shortfalls).

Our 2009 request is for $25,759,000, a $1,572,000 (or 6.5 percent) increase over 2008. The increase includes $1,060,000 for standard adjustments to base, $387,000 for four full-time equivalent positions (seven positions for approximately 6 months), and $125,000 for critical education and training programs.

Before providing more detail on this request, let me provide you with a little background on the Center and its activities. I hope with this description to convey to you the important contribution that the Center makes to the effective and efficient functioning of the Federal courts.

THE CENTER'S CONTRIBUTION TO THE COURTS

The Center's mission is to provide objective, well-grounded empirical research and balanced, effective educational programs for the courts.

The courts, and particularly the Judicial Conference of the United States, as well as Congress and the public, are regular consumers of the Center's research projects. They rely on the Center for thorough, unbiased, well-documented research. Examples include examining the impact of the Class Action Fairness Act of 2005 on the resources of the Federal courts; providing information to assist judges in handling capital cases; and developing empirically sound case weights that accurately reflect judicial workload. Not only do projects such as these help judges decide cases efficiently and fairly, they also help the judiciary and Congress make better-informed decisions about policies and procedures affecting the courts.

Center education programs are vital to judges and court staff. For new judges, orientation programs enable them to assume their new responsibilities quickly. Continuing education programs bring judges up to date on topics ranging from case-management techniques to new statutes and case law. (For example, the Center quickly responded to the U.S. Sentencing Commission's decision to retroactively apply changes to the sentencing guidelines on crack cocaine by providing educational programs and other resources to help judges, probation officers, and others deal carefully, efficiently, and fairly with the many issues this raised.)

Court staff, who play a critical role in supporting judges and ensuring the efficient operation of the courts, rely on the Center for educational programs and materials that help them do their jobs better (for example, integrating new technologies and executing cost-containment strategies). The Center's Professional Education Institute, which provides basic and advanced programs on leadership and management for managers and supervisors at all levels in the courts, is a key component of court staff training.

The Center uses a wide range of tools to deliver education. One reality of the information age is that people can (and expect to) receive information in many different ways. Where once the Center relied almost exclusively on in-person programs, audiotapes, and hard-copy publications to reach judges and court staff, we have expanded into satellite television broadcasting, teleconferencing, and use of the Internet and the courts' intranet, and, more recently, web-conferencing and streaming video. All these delivery means are needed to meet the diverse needs of a diverse population of judges, managers, and staff.

The importance of the Center's educational programs is reflected in their use by the courts. All Center training is voluntary; large numbers of judges and court staff choose to participate in Center programs and use its services because they know the Center's products will help them do their jobs better. In 2007, over 9,000 employees of the courts (including over 2,000 judges) attended Center programs in person—over half did so in their own districts. Over 1,000 court staff participated in Center

video, audio, and web conferences, and thousands of judges and court staff watched Center television programs, accessed resources and downloaded materials from the Center's intranet site, and used Center publications.

THE CENTER HAS MANAGED ITS APPROPRIATION RESPONSIBLY

Understanding the need for fiscal responsibility, the Center has made careful use of its appropriation each year. As I noted earlier, we use a wide variety of cost-effective delivery tools to provide education and information to judges and staff efficiently. The various delivery tools we use have enabled us to reach a larger and larger audience for less money than we could with only one or two of these media. But new technology also requires a highly professional staff with diverse skills in order to take full advantage of these tools and to identify and implement newer technologies as they emerge.

In-person programs remain a vital part of our education efforts. Here we economize in several ways. Most in-person staff training (and some judge education) is done by bringing faculty to the courts for local training. Most programs to which participants must travel are conducted in hotels in large cities where we can negotiate reasonable rates and take advantage of competitive airfares. We conduct smaller seminars in collaboration with several outstanding law schools, enabling us to avoid faculty and overhead costs.

We stretch our appropriation by working closely with our sister agencies, the Administrative Office of the U.S. Courts and the U.S. Sentencing Commission. We regularly consult with them to avoid duplicative efforts, and we often provide them an opportunity to convey their information to the courts at Center-sponsored programs.

THE CENTER'S FISCAL YEAR 2009 REQUEST

Our request for 2009 is modest—standard adjustments to our 2008 base, $387,000 to enable us to fill the seven positions sought but not funded in our fiscal year 2008 request, and $125,000 for programs that are needed but which we cannot currently afford without cutting equally important programs elsewhere. The seven positions will return the Center to approximately its fiscal year 2005 staffing level, but that level will still be more than 10 percent below the number of staff the Center had as recently as 2003, and over 20 percent below the number of staff employed by the Center in the early 90s. With these resources we can continue to help the courts prepare for and meet the many substantive, procedural, and operational challenges they face. The additional program funds would provide expanded programming for judges on sentencing, ethics, and case management (including the use of information technology). These additional funds would also provide programs for attorneys in the courts; the Center has not kept pace with the growing educational needs of these attorneys. The requested amounts represent a total increase of only 6.5 percent over the Center's fiscal year 2008 level. I ask you to please find the resources to fund them in full.

Thank you for your careful consideration of our request. I would be pleased to respond to any questions you may have.

PREPARED STATEMENT OF THE UNITED STATES SENTENCING COMMISSION

Chairman Durbin, Ranking Member Brownback, and members of the subcommittee, the United States Sentencing Commission thanks you for the opportunity to submit this statement in support of its appropriations request for fiscal year 2009. The Commission's statutory mission, as set forth in the Sentencing Reform Act of 1984, continues to be both reaffirmed and significantly impacted by recent United States Supreme Court decisions regarding Federal sentencing policy. Full funding of the Commission's fiscal year 2009 request will ensure that the Commission can continue to fulfill its statutory mission.

RESOURCES REQUESTED

The Commission is requesting $16,257,000 for fiscal year 2009, representing a 5 percent increase over the fiscal year 2008 appropriation of $15,477,000. The Commission recognizes that it must use its allotted resources carefully and that Congress expects the same. The Commission accordingly has tailored its fiscal year 2009 request narrowly and is seeking a limited increase over its fiscal year 2008 appropriation to account for inflationary increases and certain adjustments for personnel costs.

JUSTIFICATION FOR THE COMMISSION'S APPROPRIATIONS REQUEST

The statutory duties of the Commission include, but are not limited to: (1) developing sentencing guidelines to be determined, calculated, and considered in Federal criminal cases; (2) collecting, analyzing, and reporting Federal sentencing statistics and trends; (3) conducting research on sentencing issues in its capacity as the clearinghouse of Federal sentencing data; and (4) providing training on sentencing issues to Federal judges, probation officers, law clerks, staff attorneys, defense attorneys, prosecutors, and others.

These statutory duties and the continuing importance of the sentencing guidelines have repeatedly been reaffirmed by recent Supreme Court decisions beginning with *United States* v. *Booker*.[1] In *Booker*, the Supreme Court reemphasized the Commission's continuing role with regard to (writing Guidelines, collecting information about district court sentencing decisions, undertaking research, and revising the Guidelines accordingly."[2] In *Rita* v. *United States*,[3] the Supreme Court reinforced the role of the Commission and the importance of the guidelines in holding that a court of appeals may apply a presumption of reasonableness to a sentence imposed within the properly calculated sentencing guideline range. The Court noted that ([t]he Commission's work is ongoing. The statutes and the Guidelines themselves foresee a continuous evolution helped by the sentencing courts and courts of appeals in that process.[4] In *Gall* v. *United States*,[5] the Court reemphasized that "([a]s a matter of administration and to secure nationwide consistency, the Guidelines should be the starting point and the initial benchmark" in determining an appropriate sentence.[6]

While reaffirming the ongoing nature of the Commission's work, these decisions also have had a significant impact on that work. Consistent with *Booker* and its progeny, the Commission has continued its core mission to review and revise the guidelines, taking into account 18 U.S.C. § 3553(a) and other congressional statutes and directives and in response to information it receives from sentencing courts, Congress, the Executive Branch, Federal defenders, and others. The Commission also has increased its efforts to provide training on Federal sentencing issues, including application of the guidelines, to Federal judges, probation officers, law clerks, staff attorneys, prosecutors, defense attorneys, and others.

Furthermore, in response to these Supreme Court cases, the Commission has continued to refine its data collection, analysis, and reporting efforts to provide real-time data about Federal district court sentencing practices and trends. The Commission must continue to disseminate sentencing information in real-time and in a thorough manner so that Congress and others can be fully informed and advised on sentencing policy in the wake of the *Booker* line of cases. In addition, the Commission must continue to monitor appellate case law applying these cases, requiring the Commission to further refine its appellate court database.

Despite the impact of these cases, the Commission is not requesting program increases for fiscal year 2009. The Commission has worked diligently over the past several years to maximize its resources overall and appreciates the support and funding it has received from Congress.

Sentencing Policy Development and Guideline Promulgation

As part of its statutory duty to develop sentencing guidelines to be determined, calculated, and considered in Federal criminal cases, the Commission promulgated a number of guideline amendments during the amendment cycle ending on May 1, 2007. These amendments, which absent congressional action to the contrary became effective on November 1, 2007, related to several substantive areas of the criminal law, including transportation, terrorism, intellectual property, and drug offenses. As part of this work, the Commission updated its extensive 2002 report on Federal cocaine sentencing and amended the guidelines prescribing sentences for crack cocaine offenses, keeping the guideline penalties within the statutorily-prescribed mandatory minimum sentences. The Commission received voluminous public comment on this issue, including whether these changes should be applied retroactively. It held multiple public hearings on the amendment and the issue of retroactivity, receiving testimony from a cross-section of witnesses. Based on this testimony and its own research, the Commission decided to give retroactive effect to its amendment for

[1] 543 U.S. 220 (2005).
[2] 543 U.S. at 264.
[3] 127 S. Ct. 2456 (2007).
[4] *Id*. at 2464.
[5] 128 S. Ct. 586 (2007).
[6] *Id*. at 596.

crack cocaine offenses. It now is working closely with the Federal criminal justice community to ensure its efficient application.

For the amendment cycle ending May 1, 2008, the Commission is considering several guideline amendments in response to recent congressional action. The Commission has proposed amendments in response to the Animal Fighting Prohibition Enforcement Act of 2007, the Honest Leadership and Open Government Act of 2007, the Emergency and Disaster Assistance Fraud Penalty Enhancement Act of 2007, and the Court Security Improvement Act of 2007. The Commission also is considering amendments in the areas of immigration offenses, drug offenses, and criminal history. These proposed amendments respond to input received from the criminal justice community and reflect the Commission's ongoing work to refine the guidelines in accordance with its statutory obligations.

Consistent with the requirements of the Sentencing Reform Act of 1984, the Commission engages in a collaborative process for sentencing policy development and guideline promulgation. That process continues to include significant outreach to, and input from, representatives of the criminal justice community, as well as the review of pertinent literature, data, and case law. For example, the Commission recently held a public briefing session on disaster fraud offenses and the illegal use of human growth hormone. During this briefing session, the Commission received testimony from the Department of Justice, the Federal Defenders Service, the Department of Housing and Urban Development, the American Red Cross, and the Food and Drug Administration.

Collecting, Analyzing and Reporting Sentencing Data

In fulfillment of its statutory duties related to collecting, analyzing, and reporting Federal sentencing statistics and trends, the Commission collects documentation from the district courts on over 70,000 Federal felony and class A misdemeanor cases annually.[7] From this documentation, the Commission extracts, analyzes, and reports information on national sentencing trends and practices. As with other aspects of the Commission's statutory mission, data collection, analyzing, and reporting efforts continue to be impacted by the Supreme Court's recent sentencing-related decisions.

Immediately after the Supreme Court's 2004 decision in *Blakely* v. *Washington*,[8] the Commission recognized that one of the most critical functions it could perform was reporting timely and accurate sentencing data. The Commission refined its data collection, analysis, and reporting requirements to such a degree that it was able to produce relevant information beyond that which it promulgated in its annual reports and sourcebooks. By the time the Supreme Court issued its *Booker* decision in January 2005, the Commission was able to provide real-time data about national sentencing trends and practices.

The Commission further refined its processes throughout fiscal years 2006 and 2007 to maximize the information it made available to the criminal justice community. The Commission now provides detailed quarterly national sentencing data similar to the format and types of data produced in its year-end annual reports. In addition, the Commission has begun to provide real-time data on the impact on Federal sentencing practices of the Supreme Court's recent decisions in *Rita*, *Gall*, and *Kimbrough* v. *United States*.[9] The Commission also has expedited publication of its year-end annual reports, which are now released in February of each year. For fiscal year 2007, the Annual Report and Sourcebook contained information on 72,865 Federal cases, which represents approximately 24,000 more cases than the Commission processed a decade ago. The information contained in these reports and other analyses conducted by the Commission are used by, among others, Congress, the judiciary, the Department of Justice, defense practitioners, and academics.

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[7] *See* 28 U.S.C. § 994(w), which requires the chief judge of each district court, within 30 days of entry of judgment, to provide the Commission with: (1) the charging document; (2) the written plea agreement (if any); (3) the Presentence Report; (4) the judgment and commitment order; and (5) the statement of reasons form.

[8] 542 U.S. 296 (2004). *Blakely* was a precursor to the *Booker* decision, which applied to a State guideline sentencing scheme. After the *Blakely* decision, several Federal courts questioned whether the Federal sentencing guideline system was still viable and Federal sentencing practices became uncertain. The Commission's data collection and analysis efforts assisted the criminal justice community in evaluating the impact of *Blakely*, and later *Booker*, on the Federal system.

[9] 128 S. Ct.558 (2007).

Information Technology Issues Associated with Data Collection, Analysis and Reporting

Over the past 3 fiscal years, the Commission has apprised Congress of its development of an electronic document submission system that enables courts to electronically submit the five statutorily required sentencing documents directly to the Commission. This system is now used by 91 of the 94 judicial districts, an increase from 80 districts in fiscal year 2007 and 64 districts in fiscal year 2006. The electronic document submission system has greatly alleviated the Courts' need to spend judicial resources on copying, bundling, and mailing hard copies to the Commission.

During fiscal years 2008 and 2009, the Commission intends to continue to make technological advancements related to data collection, analysis, and reporting. For example, working with the courts, the Commission has begun to advance the evolution of its electronic submission system to a web-based system with the ability to accept both the statutorily required sentencing documents and data fields from the courts. Specific projects include the planning, coordination, and implementation of a pilot project for the expanded use of this web-based system.

Increased Requests for Commission Work Product from Congress

In addition to providing quarterly and annual data reports on national sentencing practices, the Commission continues to experience increased requests for particularized data analysis from Congress. The Commission is statutorily required to assist Congress in assessing the impact proposed criminal legislation will have on the Federal prison population. These assessments are often complex, time-sensitive, and require highly specialized Commission resources. The Commission also has experienced an increase in requests for information from Congress on issues such as drugs, gangs, fraud, immigration, and sex offenses. The Commission increasingly is providing data to assist Congress during oversight and legislative hearings on proposed changes to substantive areas of the criminal law. Informational requests from the Congressional Research Service have also increased. The Commission anticipates that congressional requests will continue to increase throughout fiscal year 2009 and looks forward to fulfilling them in a timely and thorough manner.

Conducting Research

The Sentencing Reform Act of 1984 directed the Commission to establish a research agenda as part of its role as the clearinghouse on Federal sentencing statistics and policy and to assist the courts, Congress, and the Executive Branch in the development, maintenance, and coordination of sound sentencing policies. As part of this statutory mission, the Commission issued its fourth comprehensive report on Federal cocaine sentencing policy in May 2007. It also released an analysis on the impact of the amendment to the guidelines for crack cocaine offenses if it were given retroactive effect. The Commission's research agenda in fiscal year 2008 includes reports associated with its policy work and other projects of interest to the criminal justice community. One of these projects is an examination of alternatives to incarceration, which will include a 2-day symposium featuring leading experts in the field.

Training and Outreach

The Sentencing Reform Act of 1984 also directed the Commission to provide specialized sentencing training and guidance to the criminal justice community. In fulfillment of this statutory duty, the Commission provides training, technical assistance, and other educational programs to Federal judges, probation officers, law clerks, staff attorneys, prosecutors, and defense attorneys throughout the year. The Commission's training and outreach efforts have expanded in each of the past four years, particularly in response to the Supreme Court's recent sentencing-related decisions and to the Commission's annual promulgation of guideline amendments. In fiscal years 2007 and 2008, the Commission provided training in every Federal judicial circuit and a majority of the districts. It also participated in numerous symposia, conferences, and workshops. In May 2008 in Orlando, Florida, the Commission will co-host its annual national training program at which several hundred participants will receive Federal sentencing guideline training. The Commission expects that the need to provide specialized training on Federal sentencing issues will continue to increase throughout fiscal year 2009.

SUMMARY

The Commission remains uniquely positioned to assist all three branches of Government in ensuring sound and just Federal sentencing policy. Located in the judicial branch and composed of Federal judges, individuals with varied experience in the Federal criminal justice community, and ex-officio representatives of the Execu-

tive Branch, the Commission is an expert, bipartisan body that works collaboratively with Congress. It therefore sits at the crossroads where all three branches of Government intersect to determine Federal sentencing policy.

The Commission appreciates the funding it has received from Congress to meet its ever-increasing needs. Full funding of the Commission's fiscal year 2009 request will ensure that the Commission continues to fulfill its statutory mission to develop Federal sentencing guidelines, collect, analyze and report Federal sentencing statistics and trends, conduct research on sentencing issues, and provide training to the criminal justice community. The Commission respectfully asks that Congress fully support the Commission's fiscal year 2009 appropriation request of $16,257,000 so that it can continue its statutory role as a leader in Federal sentencing policy.

Senator DURBIN. Mr. Duff, do you have a statement that you would like to add to the record?

STATEMENT OF JAMES C. DUFF, DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS

Mr. DUFF. Yes, Mr. Chairman. Thank you very much for inviting us to be here today. I am very pleased to present the budget request for the Administrative Office of the United States Courts (AO). I will make some brief remarks and ask that my written testimony be included in the record.

Senator DURBIN. Without objection.

Mr. DUFF. Thank you.

I join Judge Gibbons in thanking you for the additional funding provided the judiciary in the 2008 appropriations bill during such a tight funding environment. We sincerely appreciate your recognizing the impact enhanced border enforcement will have on the judiciary by providing emergency appropriations to address the additional workload. This funding will provide some staffing increases for courts whose workload is heavily impacted by immigration and other law enforcement initiatives.

This is my second appearance before the subcommittee. I have now had the opportunity to work with this subcommittee and its staff through one full appropriations cycle and have appreciated being able to work closely with you as our requirements changed and your allocation was reduced during conference. I want to take particular note, Chairman Durbin, of the good working relationship that we have with the subcommittee and its staff. Just this week, for example, in our executive committee meeting at the Judicial Conference, we singled out our relationship with the subcommittee as an example of how we should interact with Congress. It is exemplary, and we very much appreciate the dialogue and the subcommittee's openness and willingness to talk with us. We hope to emulate it across the board in all of our dealings with Congress. It is something we are proud of and very much appreciate.

ROLE OF THE ADMINISTRATIVE OFFICE

I will talk very briefly on a couple of items here. First, by way of background—and you may be familiar with this, but just briefly for the record—the AO was created by Congress in 1939 to assist Federal courts in fulfilling the mission to provide equal justice under the law. It is a unique entity in Government. It does not operate as the headquarters for the courts. Court operations, as you know, are decentralized, although the AO provides administrative, legal, financial, management, program, security, information technology, and other support services to all the Federal courts.

The AO also provides support staff and staff counsel to the Judicial Conference of the United States and its 25 committees and it helps implement Judicial Conference policies, as well as applicable Federal statutes and regulations. The AO has evolved over the years to meet the changing needs of the judicial branch. Service to the courts, however, will always remain our core function and mission.

REVIEW OF THE ADMINISTRATIVE OFFICE

Last year I reported to you that I was assembling a small advisory group of judges and court executives to assist me and our new Deputy Director, Jill Sayenga, in a review of the organization and mission of the AO. The ad hoc advisory group confirmed that the AO is an organization of dedicated service-oriented professionals, but it also identified some areas where the AO's performance or ways of conducting business could be improved. Teams of AO managers have been assembled to plan and implement the recommendations.

My goal is to ensure that the AO is the best and most efficient service organization in the Government. In supporting the courts, the AO frequently finds itself responding to new developments, such as the *Booker* and *Fanfan* Supreme Court decisions, or implementing the new bankruptcy legislation. And to do so, we work with court leaders to develop plans and processes for the judiciary to respond to new challenges.

CURRENT ISSUES AT THE ADMINISTRATIVE OFFICE

Two developments on which we are currently responding are the impact of enhanced immigration enforcement on the courts, and implementation of the pilot program that you authorized last year under which the U.S. Marshals Service assumes responsibility from the Federal Protective Service for perimeter security at several designated courthouses.

I will mention very briefly two other items.

Last year I spoke about the efforts to improve our working relationship with GSA. I reported that substantial progress was being made and that we were working on significant changes in how GSA determines or calculates courthouse rents. Today, I am very pleased to report that we have successfully concluded the effort on determining how GSA calculates rent.

On February 19, I signed a memorandum of agreement, which was cosigned by GSA's Public Buildings Service Commissioner, that changes the way rent will be calculated for all federally owned courthouses to be delivered in the future, and it also applies to 32 of our existing courthouses. Both the judiciary and GSA will benefit from knowing with certainty how much rent the judiciary has to pay and how much rent GSA will receive. Judiciary and GSA staff time and resources for contractor support to conduct and validate market appraisals will no longer be used.

Next, I would also like respectfully to request that you consider providing assistance in solving our two major courthouse construction problems in San Diego and Los Angeles where market conditions and delays have increased the cost of these projects.

FISCAL YEAR 2009 BUDGET REQUEST

And last, I would note that the fiscal year 2009 appropriations request for the Administrative Office of the U.S. Courts is $82 million. This is an increase of $5.9 million, or 7.8 percent. Although the increase we are seeking may appear significant, overall it represents a no-growth, current-services budget. The requested increase is exclusively to cover base adjustments to maintain current services. We are requesting no program increases.

PREPARED STATEMENT

Chairman Durbin, I recognize that fiscal year 2009 will be another difficult year for you and your colleagues as you struggle to meet funding needs of the agencies and programs under your review. I look forward to working with you and your staff on meeting the needs of the Judiciary.

Senator DURBIN. Thanks, Mr. Duff.

Mr. DUFF. Thank you.

[The statement follows:]

PREPARED STATEMENT OF JAMES C. DUFF

INTRODUCTION

Chairman Durbin, Senator Brownback, and members of the subcommittee, I am pleased to appear before you this morning to present the fiscal year 2009 budget request for the Administrative Office of the United States Courts (AO) and to support the overall request for the entire Judicial Branch.

First, I would like to join Judge Gibbons in thanking you and your Committee for the support you provided the Judiciary in the fiscal year 2008 appropriations bill. In addition to the regular funding, we deeply appreciate your recognizing the impact enhanced border enforcement will have on the Judiciary by providing emergency appropriations to address the additional workload. In the aggregate, the funding will allow the Judiciary to provide some staffing increases in courts whose workload is heavily impacted by immigration and other law enforcement initiatives.

This is my second appearance before the Financial Services and General Government subcommittee and I have now had the opportunity to work with this subcommittee and its staff through one full appropriations cycle. We recognize the very tight fiscal constraints in which you operate and appreciated being able to work closely with your staff throughout the process as our requirements changed and your allocation was reduced. I look forward to a continued productive relationship with your very able staff as we move through the year. I want to answer any questions you might have, and to describe the important needs of the Federal Judiciary.

ROLE OF THE ADMINISTRATIVE OFFICE

In July 2006, I accepted the appointment of Chief Justice Roberts to become only the 7th Director of the Administrative Office of the United States Courts in its 69-year history. Created by Congress in 1939 to assist the Federal courts in fulfilling their mission to provide equal justice under law, the AO is a unique entity in Government. Neither the Executive Branch nor the Legislative Branch has any one comparable organization that provides the broad range of services and functions that the AO does for the Judicial Branch.

Unlike most Executive Branch agencies in Washington, the AO does not operate as a headquarters for the courts. The Federal court system is decentralized, although the AO provides administrative, audit, human resources, legal, financial, management, program, security, information technology and other support services to all Federal courts. It provides support and staff counsel to the policy-making body of the Judiciary, the Judicial Conference of the United States, and its 25 committees, and it helps implement Judicial Conference policies as well as applicable Federal statutes and regulations. The AO carries out a comprehensive financial audit program to ensure the Judiciary expends its resources properly. It also coordinates Judiciary-wide efforts to improve communications, information technology, program leadership, and administration of the courts, and is leading the effort to contain

costs throughout the Judiciary. Our administrators, auditors, accountants, systems engineers, personnel specialists, analysts, architects, lawyers, statisticians, and other staff provide professional services to meet the needs of judges and staff working in the Federal courts nationwide. The AO staff also respond to Congressional inquiries, provide information on pending legislation, and prepare Congressionally mandated reports.

ADMINISTRATIVE OFFICE INTERNAL REVIEW

Last year I reported to you that I was assembling a small advisory group of judges and court executives to assist me and our Deputy Director, Jill Sayenga, in a review of the organization and mission of the AO. I wanted to ensure that the structure and services provided by the AO are appropriate and cost-effective, and that they address the changing needs of the courts. We examined our core mission of service to the courts as defined by statute and directives from the Judicial Conference to determine if internal adjustments were needed to improve efficiency and responsiveness.

I am pleased to tell you the ad hoc advisory group confirmed that the AO is an organization of dedicated, service-oriented, capable professionals, but it did identify some areas where the AO's performance or ways of conducting business could be improved. The group provided practical and achievable recommendations on how to improve both the services of the AO to, and our working relationship with, the courts. To that end, teams of AO managers have been assembled to plan and implement the recommendations. Among other things, we will be reviewing internal operations, the deployment of our workforce, the best ways to obtain court input and advice, and improvements in communications with the courts and in working procedures. My goal is to ensure that the AO is the best service organization in the Government.

Although the internal review was undertaken primarily to determine how well the AO currently fulfills its responsibilities, the ad hoc advisory group raised questions about the agency's continuing ability to deliver critical services, as well as its capacity to adapt to our court customers' future needs. Areas of concern include future budgetary constraints, the anticipated retirements of highly experienced and knowledgeable employees in senior management and technical positions, growing numbers of staff vacancies in critical areas, AO competitiveness in the labor market, the changing nature of work and required competencies, and the impact of change on employee morale.

After reviewing carefully our operations for the past year-and-a-half, I am convinced that we require the current services level of staff and funding we request for fiscal year 2009 to provide adequate support to the courts. The services provided by the AO are critical to the effective operation of our Federal courts, and I hope you will continue to provide the resources we require.

ADMINISTRATIVE OFFICE CHALLENGES

As I indicated when I testified last year, when I became Director in July 2006, I restricted recruitment actions for filling vacant positions to give me time to evaluate the organization, its mission, and priorities. Any exceptions for external recruitment were scrutinized carefully by an executive review committee and required my approval. I am pleased to report that, having completed this review, the hiring freeze has been partially lifted and critical vacancies are being filled.

In the interim, with significant additional effort on the part of our existing staff, and at times with great difficulty, the AO continues to perform vital human resources and financial functions, implements the policymaking efforts of the Judicial Conference, monitors program performance and use of resources, develops and supports automated systems and technologies, collects and analyzes court workload statistics, coordinates construction and management of court facilities, defines court resource needs through caseload forecasts and work measurement analyses, monitors the U.S. Marshals Service's (USMS) implementation of the judicial facility security program, provides program leadership and support for court unit executives, develops and conducts education and training programs, and performs cyclical court audits and other financial and system audits to ensure integrity.

In addition to striving to perform its fundamental responsibilities outlined above in the most efficient and effective matter, the AO must look beyond the immediate day-to-day needs of the courts. It is our responsibility to anticipate and plan for changes in workload, workforce demographics, legislative mandates and other areas so that we can serve the courts effectively in the years ahead.

PLANNING FOR THE FUTURE

The AO frequently finds itself in uncharted waters. Whether it is responding to the *Booker* and *Fanfan* Supreme Court decisions or implementing the Bankruptcy Abuse Prevention and Consumer Protection Act, we are working with court leaders to develop plans and processes for the Judiciary to respond to new challenges. I highlight three of the initiatives on which we are currently working—responding to enhanced immigration enforcement, preparing to implement the retroactive application of the crack cocaine sentencing amendment, and implementing a pilot project you authorized last year under which the USMS assumes responsibility from the Federal Protective Service (FPS) for perimeter security at several designated courthouses. Judge Gibbons' testimony addresses the policy issues and impact on the Judiciary of these three initiatives. I would like to talk about the operational concerns and what the Administrative Office is doing to ensure the courts are prepared to support these efforts.

Enhanced Immigration Enforcement

Increased border enforcement is a priority of this Congress and the administration. We are grateful for your recognition that the Judiciary is integral to this effort by providing significant resources to the courts in 2007 and 2008 for us to respond to the resulting apprehensions and prosecutions. In addition to having the increased funding you provided, the Judiciary must plan and coordinate the management of the new workload effectively, particularly as Operation Streamline is implemented in more locations along the Southwest border. To that end, Administrative Office staff participated in a conference of top law enforcement officials from Southwest border districts and continue to maintain contact with executive branch personnel to ensure we are aware of and can respond to their priorities. Further, we have established a task force within the AO to facilitate the Judiciary's response to enhanced immigration enforcement and work with the Southwest border courts.

In conversations with judges, court managers, and Federal defenders, particularly in the Southwest border districts, but also in districts throughout the country, we are finding that limitations beyond funding can make it difficult for courts to respond to the increased workload. Lack of space to hold court proceedings and to detain those apprehended, rising caseloads of Federal defenders, finding enough panel attorneys willing to accept these cases at the current non-capital hourly rate of $100, locating sufficient numbers of qualified interpreters, and hiring and retaining probation and pretrial services officers in the difficult work environment that exists along the Southwest border are all challenges that the AO, in coordination with the courts, is trying to address. These are difficult problems that will require creative and innovative solutions.

AO staff, in collaboration with court personnel, are systematically developing an inventory of areas where we do not have all of the resources to address the existing and potential new workload. Initially we are focusing on the Southwest border districts, but these issues are not necessarily limited to the Southwest border. Many districts throughout the country are affected by enhanced immigration efforts, resulting in increased numbers of legal and illegal alien defendants in locations such as the Middle District of North Carolina, the Western District of Arkansas, Nebraska, Idaho, the Northern District of Georgia, Oregon, Colorado, and the Southern District of Iowa. This leads, for example, to a need for more interpreters in some districts where the availability is quite limited and the demand and supply have not existed previously. To resolve these issues, we will have to look beyond the traditional ways we have addressed these needs and develop innovative, creative solutions.

Perimeter Security Pilot Program

Another new endeavor for the AO is implementation of a pilot project whereby the USMS will assume FPS perimeter security responsibilities in selected court facilities. As Judge Gibbons stated in her testimony, we are very grateful that you have given us the opportunity to pursue this project and to ensure that the Judiciary has comprehensive and effective security in place.

We are particularly troubled by the February 8, 2008, Government Accountability Office's (GAO) Preliminary Observations on the Federal Protective Service's Efforts to Protect Federal Property which found that FPS has not always maintained the security countermeasures and equipment it was responsible for, such as perimeter cameras, which may expose Federal facilities to a greater risk of crime or terrorist attack. This GAO report verifies the situation that Judge Gibbons described in testimony before this subcommittee last spring regarding perimeter security equipment for which FPS was responsible, but which was not maintained, fixed or replaced, despite FPS being paid by the Judiciary for that service. Please be assured that

courthouses do not have these problems because of the security provided the Judiciary by the USMS. It is specifically for the reasons identified in the GAO report, however, as well as the need to have one entity responsible for security, that we raised concerns about FPS perimeter security last year. We are grateful that you responded by authorizing the pilot project. The test-site courts will be provided with a consistent level of perimeter security as is the case in the interior of courthouses, and will allow those courts to rely on the Marshals Service as its single provider of security services, rather than FPS.

I would point out that GAO identified funding shortfalls as a primary cause of the FPS security deficiencies. This concerns us because, as you know, FPS is funded fully from the fees it charges other Government agencies for its security services. While we have suggested on several occasions that FPS receive a direct appropriation at a funding level Congress deems appropriate to secure Federal buildings, this proposal has not been pursued. Consequently, under the current funding scheme, any budgetary shortfall is borne by all Federal agencies in the form of increased fees, thus increasing the Judiciary's funding requirements, as well as those of the Executive Branch agencies under your jurisdiction.

With regard to the pilot project, I assure you that AO staff are involved in every aspect of implementation and will be monitoring the project carefully. We have been on site at every pilot location to assess the level of security provided by FPS and to participate in determining the appropriate level of security to be provided by USMS. We are cognizant of the need to control costs during this pilot and for the future if it is determined that nationwide implementation is appropriate.

Crack Cocaine Sentencing Retroactivity

The last new area I would like to address is implementation of the retroactive application of the Federal sentencing guidelines amendment for crack cocaine offenses. This effort is similar to our response to enhanced immigration enforcement in that it involves many components of the Judiciary as well as Executive Branch entities, as Judge Gibbons mentioned in her testimony. The AO's role in this endeavor began in November, when we hosted a contingency planning meeting prior to the decision of the Sentencing Commission to apply the amendment retroactively. We invited chief probation officers from the districts with the largest number of crack cocaine cases to meet at the AO, and we invited officials of the Sentencing Commission, the Department of Justice, and the Bureau of Prisons to join us. The discussion centered around identifying offenders in prison who may be eligible for immediate release, and planning for the successful reentry into the community of those qualified for release. At the planning meeting, two chief probation officers volunteered to host large conferences in Charlotte, North Carolina, and St. Louis, Missouri, that would gather judges, probation officers, prosecutors, and Federal defenders from districts with a significant number of crack cocaine cases, and provide a forum to develop practical plans for dealing with the workload at the district level. The 2-day conferences included presentations by the Sentencing Commission, the Bureau of Prisons, the USMS, and also panel discussions with judges, prosecutors, and defenders. There was widespread agreement at the conferences that the courts involved are capable of meeting the challenges posed by the additional workload. To ensure that the valuable information discussed during these conferences was available to all judges and court staff, AO staff recorded the sessions and posted the video on the Judiciary's intranet site.

In addition to the conferences, AO staff have worked to make implementation of the amendment easier for all of the courts. In coordination with the Sentencing Commission and the Judicial Conference's Committee on Criminal Law, AO staff developed a model order that can be used by the courts when resentencing inmates. This one-page form captures all of the information needed by the Commission and the Bureau of Prisons, and will allow judges and court staff to process the orders quickly. Also, databases used in the clerks offices, probation and pretrial services offices, and Federal public defenders offices to capture statistics and workload data related to crack cocaine resentencings have been updated. Additionally, AO staff have disseminated important information about Bureau of Prisons procedures to the courts. I am pleased to report that all of these efforts were in place prior to the March 3, 2008, effective date.

PARTNERSHIP WITH THE GENERAL SERVICES ADMINISTRATION

Last year when I testified before you I talked about my efforts to improve our working relationship with the General Services Administration (GSA). At that time I reported that substantial progress was being made and that we were working on significant changes in how GSA determines or calculates courthouse rents. Today, I am pleased to report that we have successfully concluded that effort. On February

19, 2008, I signed a Memorandum of Agreement (MOA), co-signed by the GSA Public Buildings Service Commissioner, that changes the way rent will be calculated for all federally owned courthouses to be delivered in the future. This new methodology will also be applied to a limited number of courthouses that the Judiciary already occupies.

The conventional approach that had been used to determine rent for most of our buildings, as well as those building occupied by other Federal tenants of GSA space, is based on appraisals of commercial space in the same rental market as the federally-owned building. Every 5 years a new appraisal of the market was done and rental rates paid to GSA were adjusted accordingly. I would note that using this former "fair market value" method, in fiscal year 2009, the rent for the Court of International Trade, a GSA-owned building in Manhattan that is over 40 years old, will increase by $1.5 million or 30 percent, based on the 5-year cyclical reappraisal done by GSA.

The MOA outlines a new process for determining rental rates based on a return on investment (ROI) methodology. Under the MOA, the rent will be fixed for the first 20 years of occupancy and will be set to return to GSA approximately 7 percent per year of its capital costs; operating costs will be adjusted annually to reflect GSA's actual operating expenses.

We are pleased that this MOA has been signed for several reasons. First and foremost, it ushers in a new era of collaboration and cooperation between the Judiciary and GSA and demonstrates that by working together, we can resolve problems in a way that is mutually beneficial to both parties. Second, it provides the Judiciary with certainty about the amount of rent it will pay for a 20-year time period, rather than being subject to changes every 5 years as a result of changing commercial market conditions. Third, the amount of rent will be based directly on the capital resources the Judiciary consumes, i.e., how much it costs to construct the building, rather than on periodic assessments of market rents in nearby commercial office buildings. Finally, with GSA agreeing to an "open-book" accounting of costs, the Judiciary will not have to hire consultants and expend considerable staff time reviewing appraisals based on subjective opinions of market value.

I have just outlined the many benefits that the Judiciary will enjoy under this MOA. Because this subcommittee also has jurisdiction over the General Services Administration, I assure you that GSA will also benefit from the provisions of the MOA. Specifically, GSA will have a guaranteed return on investment at a set rate with no market risk or vacancy risk. As mentioned above, under appraisal pricing, every 5 years the rate is reset. These reappraisals result in rent decreases as well as increases, so should market conditions be lower than the previous appraisal, GSA would get less rent. Also, under the MOA, the Judiciary is assuming the vacancy risk in the ROI buildings. That is, the Judiciary will pay the same rent over the 20-year time period even if space becomes vacant in the building. Consequently, GSA will not lose rental income until such time that it could backfill the space with another tenant. Finally, GSA will no longer have to respond to challenges to the fairness and validity of the rent determination process, which has led to criticism, tension, and unexpected reductions in the Federal Buildings Fund when GSA refunded overcharges to the Judiciary.

COURTHOUSE CONSTRUCTION

I next will discuss another facility-related issue—the status of our courthouse construction needs. We appreciated your willingness to fund new courthouse construction projects requested by the Judicial Conference in fiscal year 2008 even though the administration did not include them in the President's budget. We find ourselves in a similar situation this year with the President's budget only requesting the additional funds needed for the San Diego courthouse. Despite reductions in the scope of the San Diego project, costs have increased significantly over the original GSA projections because of changing market conditions and the construction boom in California. The project has been delayed several years and is critically needed in this California Southwest border district because the existing courthouse is out of space.

As you know, we have another courthouse problem in Los Angeles. California (Central) is the largest district in the country and current facilities are seriously inadequate. Because of market conditions and delays, the cost of the Los Angeles project far exceeds GSA's original estimates. Despite the sizable reductions in scope made by the court, the cost of this project continues to grow and will only get more expensive as time passes. The AO, the court, and GSA have been working together to find a solution. While we recognize how costly this project is, especially in a time of constrained resources for non-security discretionary programs, we believe the

final project design must address long-term needs and provide an environment in which the judicial process can function safely and effectively. We also want to ensure that when alternatives are considered, all costs associated with the options are included in the analysis. Consequently, we are pleased that GAO has been asked to conduct a review of this project and trust that it will address all aspects of the issue. We also look forward to collaborating with GSA on the report this subcommittee asked it to provide and trust that our views will be reflected fully. I have stated on numerous occasions that the situation in Los Angeles is an extraordinary problem that may ultimately warrant an extraordinary solution.

Finally, we respectfully request that you consider the new courthouse construction projects included on the Judicial Conference approved Five-Year Courthouse Project Plan for fiscal years 2009–2013, a copy of which is attached to this Statement. As I mentioned, none of these projects is included in the President's 2009 budget request, yet they have been on the Five Year Plan for a number of years. Most of the projects have sites, have been or soon will be designed, and are awaiting construction funding. Every year a project is not funded its cost increases by about 10 percent based solely on inflation. We appreciate your consideration of these needs.

ADMINISTRATIVE OFFICE FISCAL YEAR 2009 BUDGET REQUEST

Last I will address the fiscal year 2009 appropriations request for the Administrative Office of the United States Courts which is $81,959,000. This represents an increase of $5,923,000, or 7.8 percent, over fiscal year 2008 enacted appropriations. Although the percentage increase in appropriations we are seeking may appear significant, overall it represents a no-growth, current services budget request. I note this request funds 6 percent fewer staff than were funded in 1995 even though court staffing has increased almost 14 percent over the same time period.

The AO's appropriation comprises less than 2 percent of the Judiciary's total budget, yet the work performed by the AO is critical to the effective operation of the U.S. Courts. In addition to the appropriation provided by this Committee, as approved by the Judicial Conference and the Congress, the AO receives non-appropriated funds from sources such as fee collections and carryover balances to offset appropriation requirements. The AO also receives reimbursements from other Judiciary accounts for information technology development and support services that are in direct support of the courts, the court security programs, and defender services.

The requested increase of $5.9 million is exclusively to cover base adjustments to maintain current services; the AO requests no program increases. Over half of the increase is to fund the proposed fiscal year 2009 pay adjustment and to annualize the fiscal year 2008 pay adjustment. The balance is for inflationary adjustments and to replace non-appropriated funds (carryover) that were used to finance the fiscal year 2008 financial plan, but which at this time are expected to decline in fiscal year 2009. If carryover is not replaced with direct appropriated funds, we would be forced to reduce current on-board staffing. This would, in turn, adversely affect our ability to carry out the AO's statutory responsibilities and serve the courts. We will keep you apprised of actual carryover estimates as the year progresses. Should carryover surpass our estimates, the amount of appropriations we are requesting could be reduced.

CONCLUSION

Chairman Durbin, Senator Brownback, members of the subcommittee, I have shared with you only a few examples of the diverse issues we handle and the type of services and support the Administrative Office provides the Federal Judiciary. In addition to our service to the courts, the AO works closely with the Congress, in particular, the Appropriations Committee and its staff, to provide accurate and responsive information about the Federal Judiciary. I recognize that fiscal year 2009 will be another difficult year for you and your colleagues as you struggle to meet the funding needs of the agencies and programs under your purview. I urge you, however, to consider the significant role the AO plays in supporting the courts and the mission of the Judiciary. Our budget request is one that does not seek new resources for additional staff or programs. I hope you will support it.

Thank you again for the opportunity to be here today. I would be pleased to answer your questions.

ATTACHMENT

FIVE-YEAR COURTHOUSE PROJECT PLAN FOR FISCAL YEARS 2009–2013 AS APPROVED BY THE JUDICIAL CONFERENCE OF THE UNITED STATES ON MARCH 11, 2008

[Estimated dollars in millions]

		Cost	Score	Estimated net annual rent
Fiscal year 2009:				
Austin, TX	Add'l S&D/C	$114.0	82.0	$6.5
Salt Lake City, UT	C	168.5	67.9	11.4
Savannah GA	Add'l. D	2.0	61.3	3.5
San Antonio, TX	S	18.0	61.3	9.2
Mobile, AL	Add'l. S /C	181.5	59.8	4.7
TOTAL		484.0		35.4
Fiscal year 2010:				
Nashville, TN	Add'l D/C	164.6	67.3	7.0
Cedar Rapids, IA	Add'l D/C	136.8	61.9	6.1
Savannah GA	C	52.4	61.3	3.5
San Jose, CA	Add'l S	32.0	54.5	9.4
Greenbelt, MD	S&D	10.5	53.8	1.6
TOTAL		396.3		27.5
Fiscal year 2011:				
San Antonio, TX	C	160.8	61.3	9.2
Charlotte, NC	C	106.1	58.5	7.1
Greenville, SC	C	66.4	58.1	4.1
Harrisburg, PA	C	48.1	56.8	5.4
San Jose, CA	D	14.4	54.5	9.4
TOTAL		395.8		35.2
Fiscal year 2012:				
Norfolk, VA	C	87.8	57.4	5.1
Anniston, AL	C	17.1	57.1	1.1
Toledo, OH	C	91.8	54.4	5.9
Greenbelt, MD	C	59.0	53.8	1.6
TOTAL		255.7		13.8
Fiscal year 2013: San Jose, CA	C	188.0	54.5	9.4
TOTAL		188.0		9.4

S = Site; D = Design; C = Construction; Add'l. = Additional.

In fiscal year 2004, GSA requested only design funds for San Antonio, TX, which was planned to be built on a federally owned site. GSA advises that a privately owned site will be needed, which, therefore, requires funding to acquire a site.

All cost estimates subject to final verification with GSA.

FEDERAL PROTECTIVE SERVICE AND PILOT PROJECT

Senator DURBIN. Let me go to some questions here, if I can.

Judge Gibbons, last year when there was testimony about the adequacy or inadequacy of the Federal Protective Service, we did have a meeting and discussed options, and one of those was to extend perimeter security responsibility to the U.S. Marshals in seven different instances of primary courthouses. In your testimony, you indicated the pilot will begin in the fourth quarter of 2008 and will be in effect for 18 months.

I have a couple questions for you. Why did it take so long? Why could it not begin earlier? And second, has the performance of the

Federal Protective Service in other places—these in particular and other places as well—improved during the past year?

Judge GIBBONS. To answer the second part of it first, we are not aware of any improvements. In fact, you may be aware that there was a Government Accountability Office (GAO) report that addressed perimeter security at Federal buildings generally, not court facilities in particular, and its findings seemed similar to our observations, although the judiciary was not specifically mentioned or consulted in the course of the report.

Why did it take so long? I am not sure I can answer that directly other than in Government, these things take a while. What has to happen in each particular facility is an assessment of the needs, acquisition of the necessary equipment, and the hiring of the necessary personnel. These, of course, are court security officers who would not be already on board, and they must have the background checks, all the vetting that accompanies law enforcement or security-type employees. That is my supposition.

[The statement follows:]

While the Senate's version of the Judiciary's fiscal year 2008 appropriations bill included a provision establishing the pilot project, the House version of the bill did not include such a provision. The pilot project provision was included in the final conference agreement on the omnibus appropriations bill which was enacted into law on December 26, 2007. The Judiciary and the U.S. Marshals Service (USMS) took preliminary steps regarding the pilot project prior to and after the Senate Appropriations Committee reported its bill with the provision in July 2007, but enactment of the 2008 omnibus bill was needed in order to take definitive steps to implement the pilot project.

The current plan is to initiate contracting actions for both security systems and court security officers at all sites during fiscal year 2008. Due to contractual timelines, however, most sites will probably not be fully transitioned and ready for implementation until the first quarter of fiscal year 2009. A pilot site will only be implemented when it can be accomplished in a manner that is satisfactory to the local court, the USMS, and the Committee on Judicial Security. The actual implementation at each site will also need to take into consideration the length of time necessary for the USMS to: medically screen court security officer applicants; conduct background investigations; provide the necessary notification to the security companies that provide the FPS contract guards to stop service; and to assume control of the FPS security systems and equipment, which can vary by location.

The Moynihan Courthouse pilot was implemented in March 2008 although that site, unlike the other six sites, only involved bringing FPS equipment under USMS control. For the six remaining sites, in addition to bringing FPS equipment under USMS control, each will also require the hiring of additional court security officers which can take several months to accomplish. Of these six sites, the Dirksen Courthouse will be the next brought online. The USMS and the Committee on Judicial Security will conduct formal evaluations periodically throughout the pilot period to assess whether the program's goals are being met and to identify areas for improvement. Congress will be kept apprised of the program's status. The seven sites selected for the pilot and their planned implementation date are detailed in the table below.

Pilot Site	Planned Implementation Date
Daniel Patrick Moynihan U.S. Courthouse, New York, NY	Implemented March 2008
Everett McKinley Dirksen U.S. Courthouse, Chicago, IL	September/October 2008
Sandra Day O'Connor U.S. Courthouse, Phoenix, AZ	October/November 2008
Evo A. DeConcini U.S. Courthouse, Tucson, AZ	October/November 2008
Russell B. Long Federal Building/U.S. Courthouse, Baton Rouge, LA	October/November 2008
Old Federal Building and Courthouse, Baton Rouge, LA	October/November 2008
Theodore Levin U.S. Courthouse, Detroit, MI	November/December 2008

COURT SECURITY

Senator DURBIN. Let us go to the issue of the adequacy of the Marshals Service in gauging threat assessments against Federal judges and courthouses. The Justice Department's inspector general came up with a list of six recommendations to improve the protection of the judiciary. Five I understand were implemented. One that was not related to whether or not the Marshals Service should be notified, in addition to local law enforcement authority, of any alarm events at the home of a Federal judge. This is, of course, of special interest to us in Chicago because of the tragedy involving Judge Joan Lefkow's family not that long ago.

Does the judiciary have an opinion about whether dual notification of both law enforcement and the Marshals Service is necessary when a home alarm goes off?

Judge GIBBONS. I am not aware of whether we have taken a formal position about that. Perhaps Director Duff knows. But I am aware, at least in the district court where I formerly served in Memphis and where I am still in the same building, that in that particular district, the marshals are notified because I am aware of an incident that occurred last week in a district judge's home.

Senator DURBIN. If you could find out whether any formal position has been taken and let us know, we would appreciate it.

Judge GIBBONS. We will certainly supplement the record.

Senator DURBIN. And what is the general reaction of the judiciary to this home protection system that we have underway?

Judge GIBBONS. We are very grateful for it.

Senator DURBIN. Well, that is good to hear.

[The information follows:]

The Judicial Conference's Committee on Judicial Security has discussed the recommendation in the Department of Justice Inspector General's report concerning the response to home intrusion detection system alarm events at judges' residences. The Committee concluded that, in general, local law enforcement personnel are best suited to respond to an alarm; however, the Committee also supports appropriate coordination with the U.S. Marshals Service of instances that warrant further investigation.

COURTHOUSE CONSTRUCTION

Senator DURBIN. Now let us talk about courthouse construction. The fiscal year 2009 budget from the President provides funding for only one courthouse, the courthouse annex in San Diego. In fiscal year 2005, 4 years ago, San Diego was one of four emergency projects on the judiciary's revised 5-year courthouse project plan. Due to increased construction materials costs, the scope of the project was reduced, but the project still requires $110 million as requested by the President in fiscal year 2009 in order to be completed.

Why do emergency projects such as this not appear on the judiciary's updated 5-year plan?

Mr. DUFF. If I might answer that one, Mr. Chairman. It is because they require additional funding that needs to be sought by GSA. Our 5-year plan identifies the top priorities each year for new courthouse construction funding. What happened with regard to San Diego, as well as Los Angeles, is they encountered difficulties hiring construction companies within the funding that was pro-

vided to build the courthouse. The delays in construction have caused the cost to escalate enormously, particularly in California. And it then becomes GSA's responsibility to seek that additional funding, and while we fully support the additional funding for the new courthouses in San Diego and Los Angeles, they do not go back on our 5-year plan list. As I said, the GSA is responsible for seeking the additional funding for those courthouses.

SENIOR JUDGES

Senator DURBIN. I want to ask a question for the record on the budgetary impact of judges seeking senior status. I understand that when judges become eligible, they decrease their workload by 50 percent and relocate to other office space, freeing up their former space and staff for existing full-time judges. The senior judge is entitled to new staff, three law clerks and one administrative staffer. So all this results in requiring more resources.

How many judges are currently eligible for senior status?

Judge GIBBONS. I am not sure about that, and perhaps Director Duff can answer that.

But I do want to comment on an assumption that the question makes. Senior judges may take a 50 percent caseload. They may take a full caseload and some do. They may take variations on those two. Their space may become available. If they are taking a full caseload, the space likely does not become available, particularly if they are an appellate judge. Their need for staff and their need for space are assessed in most circuits according to the caseload they happen to be taking. So it is not really just a one-profile situation. There are many, many variations on both the caseload they take, the staff they have, and the space they occupy.

Senator DURBIN. Mr. Duff, do you know?

Mr. DUFF. I do. As of December 31, 2007, there were 473 Article III senior judges, and 92 active judges were eligible to take senior status. An additional 48 currently active judges have senior status eligibility dates between January 1, 2008, and December 31, 2008. Whether those 48 will choose to take senior status, of course, remains to be seen.

Senator DURBIN. But it sounds, in most instances, that choosing senior status will require more resources.

Mr. DUFF. Yes, in the sense that when a judge takes senior status, a new judge may be appointed, and so that does require additional resources.

Judge GIBBONS. But that is really too simplistic because if they are continuing to do work, that alleviates our need for new judgeships which come with accompanying space and staff needs. I believe about 17 percent of the overall work of the Federal judiciary is performed by senior judges.

Mr. DUFF. Yes. That is an important figure. Without our senior judges, we would be overwhelmed with work.

[The information follows:]

While there are staff and space costs associated with a judge taking senior status, it is important to emphasize that senior judges are essentially volunteering their time in continued service to the federal judiciary. A judge eligible for senior status could otherwise choose to retire and leave office at the same pay without rendering any judicial service at all. But over 400 appellate and district court judges forego full retirement, and instead take senior status and continue taking cases. They are

essential to the work of the federal courts. In 2007, senior judges participated in 19 percent of cases terminated on the merits in the appellate courts. In the district courts, senior judges handled 18 percent of the civil and criminal caseload. Both of these statistics are at the highest level in a decade.

The number of senior judges working in the courts does impact the number of new judgeships the Judicial Conference requests from Congress. If the Judiciary were to see a sharp dropoff in the number of senior judges working in the courts, it would likely result in more judgeships being requested from Congress in order to make up for the lost productivity resulting from fewer senior judges.

COURTS OF APPEALS FOR THE FEDERAL CIRCUIT

Senator DURBIN. The Federal Circuit is requesting an almost 20 percent, or $5.3 million, increase in the budget for next fiscal year. The largest part of this, $2.5 million, appears to be for staffing and leased office space and build-out for senior judges.

What is the space situation at the Federal Circuit and what is the status of judges going to senior status? Is that included in the original number that you gave me?

Judge GIBBONS. Well, actually as you know or may know, the Federal Circuit has the statutory authority to submit its own budget directly to Congress, and its budget does not go through the process of approval by the Judicial Conference, nor is it subject to the oversight of the Budget Committee. We do ask for its submission, along with our own. But I would prefer to let that court respond to its own budget submission.

Senator DURBIN. I see. So you do not talk to those people.

Judge GIBBONS. We do talk to them. I just think it appropriate that they be their own advocates.

[The information follows:]

The United States Court of Appeals for the Federal Circuit has requested in fiscal year 2009 an adjustment to the base appropriation to lease chambers workspace outside the courthouse for senior judges for whom there is no remaining space in the courthouse.

This increase for leased space, in the amount of $298,000, will help enable the Court to provide the workspace necessary for up to five additional senior judges for whom there is no remaining space in our courthouse. Four Federal Circuit judges are eligible to take senior status now, three more will become eligible in fiscal year 2009, and another judge will become eligible in fiscal year 2010.

In addition, the Federal Circuit has also requested $1,860,000 to build out leased chambers for five of the seven judges who either are now or will be eligible to take senior status in fiscal year 2009 (plus an eighth judge eligible and expected to take senior status in fiscal year 2010) and for whom there is no room in the existing courthouse. This amount is based on an estimate coordinated with the Administrative Office of the United States Courts and on personal experience with GSA in renovating chambers in this courthouse. This amount will provide the leased chambers with the furniture, furnishings and finishes consistent with the U.S. Courts Design Guide.

In fiscal year 2009 the Federal Circuit will have seven judges who are or will be eligible to take senior status. Currently, the Federal Circuit has no additional space available in the National Courts Building for senior judge chambers, and has no off-site leased space for senior judge chambers. If any of the seven judges who are or will be eligible to take senior status in fiscal year 2009 do so, there will be no available chambers for them in the National Courts Building or in off-site leased space once a replacement judge is confirmed. At least two of the seven judges who will be eligible for senior status are expected to take senior status when they become eligible in fiscal year 2009. It is imperative that the Federal Circuit acquire off-site leased chambers for the two judges who have indicated a desire to take senior status in fiscal year 2009.

By fiscal year 2010, eight of the twelve active judges on the Federal Circuit will be eligible to take senior status. If the Federal Circuit acquires off-site chambers for senior judges one chambers at a time, only after the President has been notified a judge is taking senior status, the Federal Circuit could have senior judges occu-

pying off-site leased space in eight different locations around Washington, DC, perhaps far from the courthouse. Accordingly, the Court is working with the General Services Administration and the Administrative Office of the U.S. Courts to identify and lease nearby space off-site this year (fiscal year 2008) to accommodate up to five senior judges. Five is a mid-range number the Court believes to be reasonable in providing space for fewer than all prospective senior judges but more than none or one. The number will allow for changes in decision by judges based on health or other personal issues without over-reaching by seeking off-site space for every eligible judge who may or may not choose to take senior status. Five will allow for economies of scale in long-term leasing and building out prospective chambers while reducing the risk of leaving space unoccupied.

SUPREME COURT MODERNIZATION PROJECT

Senator DURBIN. The care of the buildings and grounds fiscal year 2009 appropriation request totals $18.4 million, an increase of $6.2 million over the 2008 appropriation level. Modernization of the Supreme Court construction project began in 2004 and expected completion is the fall of this year, a total cost of $122.3 million.

Can you tell me in the most general terms—I do not want you to talk about security, obviously—what was achieved with the expenditure?

Mr. DUFF. Mr. Chairman, that was the Supreme Court?

Senator DURBIN. Yes.

Mr. DUFF. They submit their own budget request, and as I understand it, they have a hearing tomorrow, at least over on the House side. I am sure they will be pleased to respond directly to the question. We can submit it to them for their response. But their budget request is separate from the Federal courts generally.

[The information follows:]

In 2004, the Architect of the Capitol commenced a major project to provide the first significant renovation of the Supreme Court building since it was constructed in 1935.

Phase I of the project—the construction of the underground police annex, the Architect of the Capitol (AOC) shop and parking areas—was completed in late 2005. Phase II of the project—the interior building modernization—is ongoing and includes updated life safety systems, windows, mechanical, electrical, and plumbing systems. The work on one of the four building quadrants is complete. The second quadrant is scheduled for completion during the summer of 2008.

The contractor's projected completion date for the entire modernization project is September 2009. The Court and the AOC project team believe, however, that this estimate is overly optimistic and that the project will be completed in the summer of 2010. Although the building modernization project is more than a year behind, the project continues to be within budget.

The fiscal year 2009 appropriation request of $18.4 million also includes funding for two projects in addition to the modernization project: (1) landscape expenses, including repairs of driveways and walkways; and (2) the continuation of roof repairs. The Architect of the Capitol expects to request additional funds for roof repairs through fiscal year 2011.

Senator DURBIN. And before anyone is critical of this 4-year construction timetable for the Supreme Court, let me tell you we are still anxiously awaiting the opening of the Capitol Visitor Center which, according to the most recent report, will be done mañana.

RETROACTIVITY OF CRACK COCAINE SENTENCING AMENDMENT

I would like to ask about the retroactivity of crack cocaine sentencing. The U.S. Sentencing Commission promulgated sentencing guidelines that Federal trial court judges consult when sentencing defendants. Last year, the Commission amended Federal guidelines, reducing offenses under Federal sentencing guidelines for

crack cocaine. Furthermore, the Commission unanimously decided to make the policy change retroactive and the retroactivity became effective March 3 of this year.

Judge Gibbons, regarding the retroactivity of crack cocaine sentencing, is it correct that you expect not to need additional resources despite a surge of motions for reductions in sentence?

Judge GIBBONS. That is correct. There will be a lot of defendants processed with requests for resentencing by the Federal courts. And we know that obviously resources will be required to process those. Probably the biggest resource challenge will be for our probation officers who will have an increase in the numbers of individuals they will be supervising as a result of this. But we do believe that we can likely handle it within existing resources. If you want a more detailed explanation about why we think that to be so, I will be happy to go into it in more detail.

Senator DURBIN. I appreciate it.

Will crime victims be notified of an inmate's release, and will they have an opportunity to provide comment to the court prior to an inmate's release?

Judge GIBBONS. I do not think that it is required in the same way that victim notification is required in terms of an initial sentencing. But if I am incorrect about that, we will certainly let you know.

[The information follows:]

The Judiciary's Ability to Absorb Retroactivity Workload

While the U.S. Sentencing Commission estimates that approximately 19,000 inmates sentenced under the previous crack cocaine sentencing guidelines may be eligible for a reduced sentence as a result of retroactive application of the revised sentencing guidelines, it is important to note that these 19,000 would potentially be released over the course of 30 years. The Commission estimates that 3,804 of the 19,000 offenders would be eligible for a reduced sentence and early release within the first year of the effective date for retroactivity (March 3, 2008). In year two another 2,118 would be eligible, 1,967 more in year three, 1,773 more in year four and 1,353 more in year five. The remaining offenders would be eligible in year six and after. These filings will be handled by various district court components, including district judges, clerks offices, probation offices, and federal defender offices. The Judiciary believes retroactivity will have the greatest impact on its probation offices, which will supervise any crack cocaine offenders that may be granted early release, including overseeing any drug testing and treatment needs that may be imposed by a court as a condition of release.

It is generally agreed that a large number of motions for a reduction in sentence will not involve court hearings and will be decided on written filings, so the courts' workload associated with processing those cases should not be unduly burdensome. The cases that require hearings will require more court resources. At present, no extraordinary measures have been necessary to address the increased workload due to retroactivity, although additional resources will be available if needed for smaller districts that may be disproportionately impacted by the number of federal offenders seeking a reduction in sentence based on retroactivity. Given all of these factors, and the staggered nature of offenders becoming eligible for a reduced sentence, the Judiciary believes it can absorb the additional workload within existing resource levels by shifting funds as necessary to meet workload demands, including ensuring that released offenders receive close supervision by a probation officer.

Victim Notification of Early Release

Judges have been asked by the Bureau of Prisons (BOP) to delay for 10 days the effective date of any sentence reduction that results in an inmate's immediate release. This delay is needed, in part, to give the BOP adequate time to notify victims and witnesses of the offender's release, as they are required to do per 18 U.S.C. § 3771. The Judiciary is unaware if the Department of Justice will attempt to contact victims to seek comment prior to an inmate's release. It should also be noted

that due to the nature of these offenses, most cases will not have an identifiable victim within the meaning of the Crime Victim Rights Act.

WORKLOAD IN THE FEDERAL COURTS

Senator DURBIN. Statistics indicate the caseload is projected to decline in some areas, criminal, appellate, civil. What is the impact of this on the workload in the courts?

Judge GIBBONS. Well, obviously, over time our workload has trended upward. We are expecting and projecting declines in a number of areas. Those are projections done with statistical models.

Obviously, there will be impacts in all areas. We are expecting bankruptcy filings to continue to trend back upward. What happens with the economy will be a major factor likely in what happens with bankruptcy filings. We are expecting at least modest increases in supervision activity by probation and pretrial services officers. We are projecting modest declines in criminal caseload across the country, without regard to what may happen in border States and other areas with heavy illegal immigration impact, and modest declines in appellate cases, and a somewhat slightly steeper decline in civil filings. But what happens one year is not necessarily what happens the next year.

[The information follows:]

Although the Judiciary's workload has begun to level off, workload in the federal courts has increased considerably in nearly all workload categories when viewed over a 10 year perspective. As summarized in the table below, from 1997 to 2007, criminal filings increased 37 percent, the number of criminal defendants grew 27 percent, offenders under supervision of a federal probation officer increased 27 percent, the number of cases activated in the pretrial services program increased 37 percent, and appellate filings grew 13 percent. Civil filings follow a more up-and-down filing pattern from year to year and grew 3 percent overall in the last decade. Bankruptcy filings are down nearly 566,000 filings from the 1997 level due in large part to the sharp decline in filings after the Bankruptcy Abuse Prevention and Consumer Protection Act took effect in October 2005.

Workload Factor	1997 Actual [1]	2007 Actual [1]	Change 2007 vs. 1997	Percent Change 2007 vs. 1997
Criminal Filings	49,376	67,503	18,127	37
Criminal Defendants Filed	69,052	88,006	18,954	27
Probation: Persons Under Supervision	91,423	115,930	24,507	27
Pretrial Services: Cases Activated	69,959	95,955	25,996	37
Appellate Filings	52,271	58,809	6,538	13
Civil Filings	265,151	272,067	6,916	3
Bankruptcy Filings	1,316,999	751,056	(565,943)	−43

[1] Data reflects the 12-month period ending June of each year.

PAY FOR BANKRUPTCY CASE TRUSTEES

Senator DURBIN. On the subject of bankruptcy, I am still baffled, troubled, and find it hard to explain that a chapter 7 bankruptcy trustee receives $60—$60—for presiding in a no-asset case. We recently proposed raising that to $120.

Do you believe the bankruptcy trustees are entitled to a raise in compensation in no-asset cases?

Judge GIBBONS. Well, I am not sure. Can we get back to you on that? I have some information about it somewhere in this material, but you probably do not want to sit there while I try to locate it.

And it is not coming to the top of my head whether we have a position about that or not.

Senator DURBIN. It is not a trick question.

Judge GIBBONS. No, I know.

Senator DURBIN. We will let you provide that later.

[The information follows:]

The Judicial Conference has no position on the amount of compensation Congress deems appropriate for chapter 7 case trustees. However, the Judiciary in the past has expressed its opposition to any case trustee compensation increase that is made at the Judiciary's expense. If the Judiciary were required to pay the case trustees an additional $60 per case and did not receive a specific appropriation for that purpose, it would cost the Judiciary $30 million which could mean the loss of 375 FTEs.

Senator DURBIN. Unless there is anything further you would like to add, I want to thank you for participating in this hearing. I appreciate all of the work you did to prepare your testimony and to answer my questions. I think this forum has given us some further insights into judiciary operations.

ADDITIONAL COMMITTEE QUESTIONS

The hearing record is going to remain open for a period of 1 week until Wednesday, March 19 at noon for subcommittee members to submit statements and/or questions for the record, which we hope you can answer in a timely fashion.

[The following questions were not asked at the hearing, but were submitted to the judiciary for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

COURT SECURITY—U.S. MARSHALS SERVICE

Question. Your fiscal year 2009 budget request seeks 17 new U.S. Marshals positions (9 FTE). Why are these additional positions needed? Are they new positions or are they replacing vacancies?

Answer. For fiscal year 2009, the U.S. Marshals Services (USMS) requests 17 new Judiciary-funded positions (9 FTE) for a total of 64 full-time positions (56 FTE). These are new positions, not backfills. The Judiciary currently funds 47 full-time USMS positions to administer the Judicial Facility Security Program. This program includes the Office of Court Security, which is responsible for the daily operations and personnel management of the court security officer (CSO) program; the Office of Security Contracts, which is responsible for the daily contract responsibilities with the private contractors and the district contracting officer's technical representatives; the Office of Security Systems, which is responsible for all security and monitoring systems for judicial space; and the Office of Financial Management, which is responsible for the daily oversight responsibility on financial matters.

A summary of the requested positions is listed below:

—The Office of Security Systems requests funding for five additional physical security specialists and one administrative assistant/management support specialist in order to keep up with the workload that has resulted from expanding responsibilities and additional oversight duties. The court security equipment program has changed dramatically over the past few years, and program requirements and oversight responsibilities have increased significantly. This occurred as a result of the growth of the court security systems program and focus on improved security procedures, systems technologies and maintenance. The additional personnel are required to keep pace with these expanded duties.

—The Office of Court Security requests funding for four program analyst positions to manage the growing workload in medical evaluations for CSOs, and the new background investigation requirements for CSOs mandated by Homeland Security Presidential Directive 12.

—The Office of Security Contracts (OSC) requests funding for one supervisory contract specialist and two contract specialists. Over the past several years, the dollar value of contracts has grown significantly, as has the number of procurement actions required to support the JFSP. Staffing has not grown to match

the increase in workload. Currently, the OSC has two supervisory contract specialists, six contract specialists, and a chief. In light of workload increases, the current number of contract specialists is insufficient. To provide appropriate contract management, including an expanded audit capability, three additional positions are required.

—The Office of Financial Management requests funding for one additional budget analyst to address the increased workload of the Judicial Facility Security Program. The Office of Financial Management currently has a staff of five, consisting of a chief, deputy chief and three budget analysts.

—Two new equal employment opportunity counselors are requested to handle the growing number of equal employment opportunity (EEO) complaints filed by CSOs. Previously, EEO counselors handing CSO complaints have been funded through the USMS's Salaries and Expenses account and represented a relatively small number of total EEO workload. With the growth in EEO activity, this request will ensure that the Judiciary's Court Security appropriation properly funds the USMS's costs associated with administrating the court security program.

—The Technical Operations Group requests funding to convert a contractor position to a program analyst to provide the necessary financial, administrative and contractual expertise to support the Courthouse/CSO Radio Program. Funding for the current contractor position will be used to partially offset the cost of this position. Contractors are limited in the duties that they can perform so this conversion will provide an employee who can perform all procurement duties.

COURT SECURITY—DEPARTMENT OF JUSTICE INSPECTOR GENERAL REPORT

Question. Last September, the Justice Department's Inspector General released a report indicating a continued problem with the Marshals Service and their effectiveness in gauging threat assessments against federal judges and courthouses. The IG's report said the Marshals Service had a backlog of threat assessments and was slow in staffing a new office designed to collect and analyze information on potential threats.

The IG's report made six recommendations for the Marshals Service to improve its protection of the Judiciary. In its response to the recommendations, the Marshals Service said it would follow five of them.

The one item that the Marshals Service disagreed with was the recommendation to require that the Marshals Service, in addition to local law enforcement, be notified of all alarm events at the home of a federal judge. This is of particular interest to me because my colleague Senator Obama and I initiated the home alarm program for federal judges after the tragic killings of Judge Lefkow's husband and mother inside her home.

Does the Judiciary have an opinion about whether dual notification—of both local law enforcement and the Marshals Service—is necessary when a home alarm goes off?

Answer. The Judicial Conference's Committee on Judicial Security has discussed the recommendation in the Department of Justice Inspector General's report concerning the response to home intrusion detection system alarm events at judges' residences. The Committee concluded that, in general, local law enforcement personnel are best suited to respond to an alarm; however, the Committee also supports appropriate coordination with the U.S. Marshals Service of instances that warrant further investigation.

Question. Has the Marshals Service implemented the other five recommendations of the IG's report relating to threat assessments?

Answer. We understand that, with the exception of one recommendation for the USMS to develop a formal plan that defines objectives, tasks, milestones, and resources for implementing a protective intelligence function to identify potential threats, the USMS has responded to the other four recommendations in the IG's report relating to threat assessments. Specifically, the USMS has: (1) developed a formal plan that defines objectives, tasks, milestones, and resources for the new threat assessment process; (2) created a workload tracking system for threat assessments; (3) modified the USMS databases to support the new threat assessment process and protective intelligence function to identify potential threats; and (4) issued operational guidance for requesting and deploying Technical Operations Group resources and Rapid Deployment Teams.

Question. In your testimony, you indicated the Marshals Service established a new Threat Management Center last September which you said "serves as the nerve center for responding to threats against judges and court personnel."

Do you believe this new Threat Management Center has helped the Marshals Service implement the recommendations made in the IG's report?

Answer. Yes. The Threat Management Center (TMC) that is part of the Office of Protective Intelligence at the USMS and was opened in September 2007 provides a 24/7 response capability for intake and review of threats made against the Judiciary. A new threat analysis process was initiated, and weekly and monthly reports about pending threats against the Judiciary are now produced. A workload tracking system for the TMC has been developed to insure a backlog of threat assessment does not occur again. Additional staffing for the TMC in fiscal year 2007 has also enabled the USMS to dedicate more resources to investigating and responding to threats in a more timely manner.

Question. In its September 2007 report, the Inspector General at the Justice Department indicates it conducted a survey of federal judges regarding implementation of the home alarm program that Senator Obama and I initiated. According to the IG's study, 88 percent of federal judges said they were "very" or "somewhat" satisfied with the home alarm program. About the same number of federal judges, 87 percent, said they were "very" or "somewhat" satisfied with the Marshals Service performance in providing protection.

Judge Gibbons, I realize you're the chair of the Judicial Conference's Budget Committee, not the Judicial Security Committee, but can you give us a sense of how the Marshals Service could do a better job with the home alarm program?

Answer. First, I would like to thank the Subcommittee for its support of such an important program to protect judges and their families at home. The Judiciary and the USMS worked hard to make sure that the money Congress appropriated for this project was spent wisely, and that every judge who wanted a home alarm system received one. We have heard very few complaints associated with USMS's implementation of the alarm program. I would add that the USMS has been responsive to our needs when questions have arisen about the program.

Question. Has every federal judge who wanted a home alarm system had one installed at this point?

Answer. To the best of our knowledge, yes. As of March 11, 2008, 1,565 judges have participated in the program and have a home alarm system.

Question. Can you give us a sense of how the Marshals Service could do a better job with their overall mission of providing protection to the Judiciary?

Answer. The biggest challenge facing the USMS is securing adequate resources to make sure their statutory mission to protect the federal Judiciary is realized. The continued budgetary constraints on the staff of deputy U.S. marshals (funded through the USMS's Salaries and Expenses account, not the Judiciary's Court Security account) for courthouse operations is troubling, especially in light of new Executive Branch initiatives such as Operation Streamline that will increase the volume of defendants being produced in courts along the southwest border.

Question. In your testimony, you asked for an increase of $4 million "for necessary investments in court security, such as court security systems and equipment and new positions at the U.S. Marshals Service (9 FTE)." Please describe in more specific detail what the $4 million would go toward and why you think it's necessary above and beyond the current allocation.

Answer. The $4 million requested for program increases will provide funding for 17 new U.S. Marshals Service positions as explained in the response to the question above ($1.1 million); one new contractor position at the U.S. Marshals Service ($124,000); rent reimbursement to the U.S. Marshals Service for Judiciary funded positions ($710,000); reimbursement to the U.S. Marshals Service for EEO investigations ($123,000); and additional security systems and equipment ($2.0 million).

The request of $124,000 is for a contract electronics technician position to handle the increase in troubleshooting and repair of infrastructure and portable radio equipment than is currently possible by the sole program manager on board. Funding is essential for the continued success of the program with respect to the nationwide reprogramming and encryption goals set forth in fiscal year 2007 and beyond. Without funding, the USMS's efforts to encrypt all CSO radios nationwide will be further delayed.

The request of $710,000 would allow the Administrative Office (AO) of the U.S. Courts to reimburse the USMS headquarters for the space occupied by Judiciary-funded USMS staff. The AO currently transfers funding to the USMS to fund personnel compensation and benefits and other costs necessary to administer the Judicial Facility Security Program. In the past, the transfer has not included funding for associated rent costs.

The request of $123,000 is to reimburse the USMS for contractors hired by the USMS to investigate, process and resolve the anticipated increase in EEO complaints filed by CSOs. This request will ensure that the Judiciary's Court Security

appropriation properly funds the USMS's costs associated with administrating the court security program.

A $2 million increase is requested for cyclical replacement of access control head end computers. On August 27, 2004, President Bush signed Homeland Security Presidential Directive (HSPD)-12 for the purpose of establishing a mandatory, government-wide standard for security and reliable forms of identification, known as the Personal Identity Verification (PIV) ID Card, to be issued by Executive Branch agencies to its employees and contractor staff. This new initiative consists of upgrading and replacing access control systems nationwide to meet HSPD–12 compliance requirements, as well as the implementation of a cyclical replacement program for these systems. Finally, since this is going to be the standard ID card for the majority of government employees and long-term contractors, Judicial Branch employees and contractors will need the card to facilitate access to federal facilities.

IMPLEMENTATION OF THE COURT SECURITY IMPROVEMENT ACT

Question. Less than three months ago, Congress passed and the President signed the Court Security Improvement Act of 2007. This is one of the most comprehensive court security bills ever passed by Congress. One of the provisions requires the Marshals Service to consult with the Judicial Conference on a continuing basis regarding court security.

Has this provision been implemented yet? Has a consultation process begun between the Marshals Service and the Judicial Conference?

Answer. Even prior to the enactment of the Court Security Improvement Act of 2007, the relationship between the USMS and the Judicial Conference had improved dramatically under the leadership of the current USMS Director John Clark. In addition, in October 2005 the Judicial Conference created a Committee on Judicial Security to focus solely on security issues for the Judiciary and to liaison with the USMS. Since that time, the USMS has attended the bi-annual meetings of the Committee to discuss issues of importance to the court security program.

An example of the consultation process that exists between the USMS and the Judicial Conference is the recent pilot project that was approved in the fiscal year 2008 omnibus appropriations bill for the USMS to assume perimeter security protection from the FPS at select primary courthouses. The judges on the Committee on Judicial Security have consulted extensively with the USMS to craft a pilot program that is both responsive to the Judiciary's needs and reflective of budgetary constraints.

Question. Have other provisions of the Court Security Improvement Act been implemented yet? Is everything going smoothly so far? If not, what are the impediments?

Answer. Implementation of provisions that directly impact the Judiciary in the new law appear to be going smoothly although it remains to be seen whether the $20 million per year in appropriations through 2011—authorized in section 103 of the Act for the USMS to hire additional deputy marshals—will be provided. There are multiple provisions in the Act that do not directly affect the Judiciary, so the Judiciary has no view regarding those.

COURTHOUSE CONSTRUCTION (SAN DIEGO AND LOS ANGELES)

Question. The fiscal year 2009 President's budget provides funding for only one courthouse—the Courthouse Annex in San Diego. In fiscal year 2005, San Diego was one of four emergency projects on the Judiciary's Revised Five-Year Courthouse Project Plan (fiscal years 2005–2009). Due to increased construction materials costs, the scope of the project was reduced but the project still requires $110 million, as requested by the President in fiscal year 2009, in order to be completed. The Los Angeles courthouse project is in a similar situation, requiring much more funding. What is the latest on that project?

Answer. The courthouse problem in Los Angeles is a serious one. The Central District of California is the largest district in the country and current facilities are completely inadequate, primarily because of an insufficient number of courtrooms to meet the growing needs of the district court and significant security issues at the current location. Market conditions and delays have created a price tag for the Los Angeles project that far exceeds GSA's original estimates. Despite the sizable reductions in scope already made by the court, the cost of this project continues to grow and will only get more expensive as time goes on. The AO, the court, and GSA have been working together to find a solution.

While the Judiciary recognizes how costly this project is, especially in a time of constrained resources for non-security discretionary programs, we believe the final project design must address long-term needs and provide an environment in which

the judicial process can function safely and effectively. The Judiciary also wants to ensure that when alternatives are considered, all costs associated with the options are included in the analysis. Consequently, the Judiciary is pleased that GAO has been asked to conduct a review of this project and trusts that it will address all aspects of the issue. The Judiciary's understanding is that GAO will look into the reasons for the delay, the effects of the delay, and the challenges faced in managing this project. The Judiciary looks forward to receiving GAO's findings.

BUDGETARY IMPACT OF JUDGES ASSUMING SENIOR STATUS

Question. My understanding of senior status is when judges become eligible for senior status, they decrease their workload by 50 percent, and need to relocate to other office space, freeing up the former space and staff for an existing full-time judge. Then the senior judge is entitled to new staff: 3 law clerks and one administrative staff. So, all this results in requiring more resources (for which less work may be accomplished).

Answer. Many senior judges do not reduce their workload by 50 percent. Many continue to carry a full caseload. There is no specific workload requirement for senior judges although a senior judge must perform "substantial judicial work" to employ staff and receive "suitable quarters." The number of staff the senior judge receives must relate directly to the workload he or she performs. An annual certification process in place considers projected and actual workload in order for a senior judge to continue having office space and staff support.

While there are staff and space costs associated with a judge taking senior status, it is important to emphasize that senior judges are essentially volunteering their time in continued service to the federal Judiciary. A judge eligible for senior status could otherwise choose to retire and leave office at the same pay without rendering any judicial service at all. But over 400 appellate and district court judges forego full retirement, and instead take senior status and continue taking cases. They are essential to the work of the federal courts. In 2007, senior judges participated in 19 percent of cases terminated on the merits in the appellate courts. In the district courts, senior judges handled 18 percent of the civil and criminal caseload. Both of these statistics are at the highest level in a decade.

When Article III judges take senior status, they continue to receive the salary they were earning at the time they left active service. For a senior judge to receive the same cost of living increases as an active Article III judge, the senior judge must perform at least 25 percent of the work performed by "an average judge in active service." 28 U.S.C. §§ 371(b)(1), (e)(1).

The number of senior judges working in the courts are taken into consideration when determining the number of new judgeships the Judicial Conference requests from Congress. If the Judiciary were to see a sharp dropoff in the number of senior judges working in the courts, it would likely result in more judgeships being requested from Congress in order to make up for the lost productivity resulting from fewer senior judges.

Question. How many judges are currently eligible for senior status?

Answer. As of December 31, 2007 there were 473 Article III senior judges, and 92 active judges were eligible to take senior status. An additional 48 currently active judges have senior status eligibility dates between January 1, 2008 and December 31, 2008.

Question. Of those, how many have been eligible for more than one year?

Answer. Of the 92 active judges that were eligible to take senior status as of December 31, 2007, 77 had been eligible to take senior status prior to January 1, 2007. The other 15 active judges became eligible for senior status during 2007.

Question. So, this means that the Judiciary must continually request funding for space and staffing for senior judges—and sometimes you receive this funding—but you may not always need it?

Answer. The Judiciary does not assume that all judges eligible to retire or take senior status will in fact do so. The Judiciary uses historical patterns to estimate the number of judges that will retire or take senior status. In formulating the fiscal year 2009 budget request, the Judiciary estimated that 33 of the 55 judges eligible in fiscal year 2009 will retire or take senior status. Based on the Judiciary's projection of when judges would retire/take senior status during the year, the Judiciary estimates that the 33 judges would equate to 20 FTE for budget purposes. Of the 20 FTE, 18 are projected to take senior status and continue taking cases, and two to retire and leave the federal bench.

In the event fewer judges take senior status than the Judiciary requested funding for, that funding is carried forward to offset the Judiciary's appropriation requirements in the following fiscal year. However, the Judiciary endeavors to provide the

Appropriations Subcommittees with the most accurate projection of judges expected to take senior status. As is done each year, the Judiciary will continue to refine its estimates of judges retiring/taking senior status and will update the Appropriations Subcommittees—through the 2008 Spring and Fall budget re-estimate process—on any changes to senior judge projections that will impact the Judiciary's fiscal year 2009 appropriation requirements.

SENIOR JUDGES AT THE COURT OF APPEALS FOR THE FEDERAL CIRCUIT

Question. The Federal Circuit is requesting an almost 20 percent (or $5.3 million) increase in its budget for fiscal year 2009. The largest part of this increase ($2.5 million) appears to be the staffing, and leased office space and build-out for senior judges.

[CLERK'S NOTE.—The Court of Appeals for the Federal Circuit's budget request does not fall under the jurisdiction of the Judicial Conference of the United States and its Budget Committee. Accordingly, this response was prepared by the Federal Circuit and its Chief Judge Paul R. Michel.]

What is the space situation at the Federal Circuit and what is the status of judges going to senior status?

Answer. Federal Circuit Judges occupy every judge's chambers available to the Federal Circuit in the National Courts Building complex. (The building complex houses two courts, and both courts have assigned all available chambers space to judges.) This includes one sub-standard chambers on the ground floor of Dolley Madison House. That chambers has historically been used as swing space or to house visiting judges temporarily sitting by designation, or for other special purposes. There is no other space suitable or available to judges. The Federal Circuit has no vacant and unassigned chambers, and none is anticipated.

In fiscal year 2009 the Federal Circuit will have seven judges who are or will be eligible to take senior status. Today the Federal Circuit has no space available in the National Courts Building for even one additional senior judge and has no off-site leased space for them, either. If any one of the seven judges who is or will be eligible to take senior status in fiscal year 2009 does so, there will be no chambers available in the National Courts Building or in off-site leased space once a replacement judge is confirmed. At least two of the seven judges who will be eligible for senior status are expected to take senior status when they become eligible in fiscal year 2009. The Federal Circuit must acquire leased space off-site for the judges who have indicated a desire to take senior status in fiscal year 2009 and 2010.

Note about staffing for a senior judge: Historically, senior judges at the Federal Circuit work less than 50 percent of an active judge's caseload and are therefore entitled by rule to only one law clerk.

Question. So, the Federal Circuit seeks the funding associated with senior status, not knowing whether the judges will actually take senior status?

Answer. As a rule, no one knows when a judge will decide to take senior status except that judge. Timing can be highly personal, and advance notice varies for each individual. There are strong indications that at least one of the judges eligible to take senior status in fiscal year 2009 plans to do so, and that at least one additional judge will choose to take senior status in fiscal year 2010. By fiscal year 2010, eight of the twelve active judges on the Federal Circuit will be eligible to take senior status. If the Federal Circuit acquires off-site chambers for senior judges one chambers at a time, only after the President has been notified that a judge is taking senior status, the Federal Circuit could have senior judges occupying off-site leased space in as many as eight different locations around Washington, DC, perhaps far from the courthouse. Logistics, security, and transportation would be challenges, and judges would feel isolated from their colleagues. Accordingly, the Court has been working with the General Services Administration and the Administrative Office of the U.S. Courts to lease nearby off-site space this year (fiscal year 2008) to accommodate up to five senior judges in the next two years. Five is a mid-range number the Court believes to be reasonable in providing space for prospective senior judges. The number will allow for changes in decision by judges based on health or other personal issues without over-reaching by seeking off-site space for every eligible judge who may or may not choose to take senior status. Five chambers will allow for economies of scale in long-term leasing and building out prospective chambers while reducing the risk of leaving significant space unoccupied.

Question. What happens if the funding is provided and the judges do not take senior status?

Answer. The chambers will remain available until occupied by whichever judge needs them. If Judge A does not take senior status in fiscal year ____ the chambers will remain available for Judges B, C, D, etc. As described above, it is virtually cer-

tain that off-site chambers will be occupied in the next two years by at least one judge and most probably by at least two judges, although not all chambers will likely be occupied at the outset. It is possible that housing senior judges together in suitable space near the courthouse will induce judges to take senior status when they wish to take it, knowing they have appropriate space in close proximity to their colleagues. It takes time to find suitable space, negotiate a lease through GSA, and design and complete the build out. The Court has been at this effort for several years and is very nearly out of time. Funds appropriated to house senior judges will not be wasted, and space will be available even on short notice to accommodate situations that arise with little or no advance warning.

IMPACT OF INCREASED BORDER ENFORCEMENT

Question. Our borders, particularly the Southwest Border, have been an area of increased enforcement in order to combat illegal immigration over the past several years. Because that increased enforcement results in more cases in the courts, we have provided the Judiciary with additional resources to manage that workload. Director Duff, your testimony indicates that this increased enforcement affects other parts of the country, not only the Southwest Border. Please discuss this in further detail as well as the resulting implications.

Answer. The increased emphasis by Congress and the Administration on immigration enforcement has had the greatest impact on the five federal district courts along the Southwest border with Mexico. Other districts throughout the country, however, have also been impacted by this increased enforcement. In 2002, there were 11,791 criminal cases for violations of federal immigration laws. Of these, 7,735 cases were in the five Southwest border district courts and 4,056 cases were in the remaining 89 judicial districts. In 2007, there were 15,898 criminal cases for violations of federal immigration laws. Of these, 10,953 were in the Southwest border courts, and 4,945 were in the remaining 89 judicial districts. Non-border immigration caseload in the federal courts increased 22 percent in this five year period. Immigration-related cases can present challenges to a court, including the need to hire or contract for qualified interpreters to assist in court proceedings.

Increased immigration enforcement has impacted our appellate courts as well. Challenges to Board of Immigration Appeals (BIA) decisions in the appellate courts totaled 1,777 cases in 2001, peaked at 12,725 cases in 2006, then declined to 9,338 cases in 2007—a more than 400 percent increase over 2001. About one-third of all BIA decisions are challenged in the federal appellate courts with 70 percent of those challenges occurring in the Second and Ninth Circuits. While BIA appeals have dropped in the last year, these cases continue to demand extensive resources since they often turn on a credibility determination by a Department of Justice immigration judge, thus requiring close judicial review of a factual record by the appellate courts.

The Judiciary will utilize the additional resources provided by Congress to respond to workload needs throughout the federal court system and not just on the Southwest border.

JUDICIAL AUTHORITY FOR OFFENDER RE-ENTRY PROGRAMS

Question. I have supported offender reentry programs like job training, education, drug and mental health treatment for many years, as part of the effort to reduce criminal recidivism. Does the Judiciary have the legislative authority it needs to increase the likelihood of successful offender reentry into the community and positive outcomes for post-conviction supervision?

Answer. The Judicial Conference believes it needs explicit authority to permit the Director of the Administrative Office to contract for non-treatment services (e.g., medical, educational, emergency housing, and vocational training) and other reentry interventions for post-conviction offenders generally. At its September 2005 session, the Conference approved proposed language which was submitted to Congress on November 14, 2005. Specifically, the proposed legislation amends 18 U.S.C. § 3672 to allow the AO Director to contract for re-entry services, including treatment, equipment, emergency housing, vocational training, and other re-entry interventions. I am pleased to report this provision was included in the Second Chance Act which was signed into law on March 30, 2008 (Public Law 110–199).

The Judicial Conference also supports legislation that would amend 18 U.S.C. § 3154 to authorize the AO Director to contract for similar services for defendants released pending trial, and to amend both 18 U.S.C. § 3154 and 18 U.S.C. § 3672 to authorize the Director to expend funds for emergency services for defendants on pretrial release and offenders on post-conviction supervision respectively. This proposed legislation was submitted to Congress on April 16, 2007.

Expansion of the Director's authority will allow probation and pretrial services officers to obtain contract services for all persons under their supervision who need them. Research consistently indicates that certain approaches yield demonstrable and measurable results in the reduction of recidivism. With expanded authority, officers will make greater use of practices such as cognitive-behavioral treatment, job training, and employment placement programs that have been proven effective in obtaining successful outcomes and making the community safer.

The addition of authority to expend funds for emergency services for defendants on pretrial release and offenders on post-conviction supervision respectively would provide officers with the ability to deal with day-to-day incidental expenses. Officers often use their own personal money to assist offenders with small expenditures such as bus fare to go for a job interview.

Of course, if expenditure authority is enacted, guidance and clarification would be developed to ensure that it is used appropriately. Some of the issues requiring clarification would include the type of "emergency" services that are authorized and the spending limit.

RENT SAVINGS

Question. Over the past few years, the Judiciary has realized substantial savings (more than $50 million) in rent overcharges from the General Services Administration. Judge Gibbons, your testimony indicates that another $10 million savings is expected in fiscal year 2008. Now that you and GSA are working cooperatively in this effort, at what point do you expect this savings to level off (or do you expect to continue to have a savings in the tens of millions)?

The Judiciary believes it is important to continue to work with the courts and GSA to compare the space actually occupied by the courts to the space assignment drawings used by GSA. These drawings are used to establish the basis for rent bills and it is therefore very important that they are accurate. The Judiciary and GSA have recently revised the existing approach to verifying the assignment drawings to the space actually occupied and to adjust the rent bill in connection with errors identified during rent validation so that rent bill adjustments for overcharges can be performed on a more expedited basis. Although we believe that the major rent overcharges have been identified and corrected, savings will continue to be realized if further overcharges are identified during our ongoing and continuous reviews of GSA rent bills.

A second initiative underway for the Judiciary is the review of GSA appraisals used to set rental rates to ensure their accuracy. It is uncertain at this time whether this review will result in significant savings for the Judiciary.

PROJECTS UNDER THE "CARE OF THE BUILDING AND GROUNDS OF THE SUPREME COURT"

Question. The Care of the Building and Grounds fiscal year 2009 appropriation request total $18.4 million, an increase of $6.2 million (51.2 percent) over the fiscal year 2008 appropriation level. Modernization of the Supreme Court construction project began in 2004 and expected completion is the fall of this year, costing a total of $122.3 million.

[CLERK'S NOTE.—The Supreme Court's budget request does not fall under the jurisdiction of the Judicial Conference of the United States and its Budget Committee. Accordingly, this response was prepared by the Supreme Court.]

What was achieved with this expenditure of funds?

Answer. Phase I of the project—the construction of the underground police annex, the Architect of the Capitol (AOC) shop and parking areas—was completed in late 2005. Phase II of the project—the interior building modernization—is ongoing and includes updated life safety systems, windows, mechanical, electrical, and plumbing systems. The work on one of the four building quadrants is complete. The second quadrant is scheduled for completion during the summer of 2008.

The contractor's projected completion date for the entire modernization project is the summer of 2010. Although the building modernization project is more than a year behind, the project continues to be within budget.

Question. Do you expect any further modernization needs in the short-term future?

Answer. The Court does not foresee further modernization requirements outside the current scope of the modernization project. With the project two years away from completion, however, unforeseen circumstances may arise that would require a request for additional funding.

Question. Separate projects include the exterior property renovation/landscaping project and the roof system project. For fiscal year 2009, the Supreme Court is requesting $6.3 million to complete construction to renovate the exterior landscape of

the Supreme Court as well as $2.1 million for phase 2 (of 5 phases) to repair the roof, which is to be completed in 2011. Once the modernization, property renovation/landscaping, and roof projects are completed, will Care of the Buildings and Grounds of the Supreme Court go back down to a maintenance request level or are further projects anticipated in the near future?

Answer. When the modernization project is completed, approximately $3 million will be needed to complete the installation of the perimeter security plan around the Court building and grounds. Additional funding will also be needed to complete the planned roof repairs. Although some funding has been already provided to restore the stone sculptures of the East and West pediments and roof perimeters of the building, it is likely that more funding will be needed to repair and restore the stonework in the building's four interior courtyards. At this time, no other major projects are anticipated, and future funding requests should be more in keeping with normal maintenance-level requirements for the care of the building and grounds.

RETROACTIVITY OF CRACK COCAINE SENTENCING AMENDMENT

Question. The U.S. Sentencing Commission, an independent agency within the Judiciary, promulgates the sentencing guidelines that federal trial court judges consult when sentencing defendants convicted of federal crimes. Last year, the Sentencing Commission amended federal guidelines reducing offenses under federal sentencing guidelines for crack cocaine offenses. Furthermore, the Commission unanimously decided to make the policy change retroactive and this retroactivity became effective on March 3, 2008.

Will crime victims be notified of an inmate's release and will they have an opportunity to provide comment to the court prior to an inmate's release?

Answer. Judges have been asked by the Bureau of Prisons (BOP) to delay for 10 days the effective date of any sentence reduction that results in an inmate's immediate release. This delay is needed, in part, to give the BOP adequate time to notify victims and witnesses of the offender's release, as they are required to do per 18 U.S.C. § 3771. The Judiciary is unaware if the Department of Justice will attempt to contact victims to seek comment prior to an inmate's release. It should also be noted that because of the nature of these offenses, most cases will not have an identifiable victim within the meaning of the Crime Victim Rights Act.

Question. What measures are U.S. probation offices taking to address community safety issues and to ensure a smooth transition for inmates released into the community?

Answer. Probation officers will play a key role in recalculating the inmate's amended guideline range and identifying any post-sentence conduct that may impact the judge's decision. Officers will do that in part by reviewing the inmates disciplinary records and progress reports that are prepared by the BOP. Officers were recently provided with refresher training for the BOP's Sentry system, which allows officers to access information on an inmate's performance while in the BOP. If the officer identifies a risk that cannot be addressed by the conditions originally imposed, the probation officer may ask the court to modify or impose additional conditions of supervised release. These may include conditions for halfway house placement, drug or mental health treatment, or home confinement.

Prerelease planning ordinarily begins several months before an inmate's release, and addresses issues such as an inmate's release residence, continuity of any treatment, and potential employment. It is possible that some offenders will receive a sentence of time served and not have a pre-release plan in place. In such cases, the probation officer and BOP staff will use the 10-day period requested by the government to develop a plan for the inmate's release. The probation officer and BOP staff will prioritize the inmate's needs and attempt to address as many as possible before the inmate's release. Most pressing will be to identify an appropriate release residence. Once released, the officer will conduct a thorough assessment and make any necessary referrals to assist the offender in his or her reentry back to the community.

Question. Please discuss your post-conviction supervision program. How do you determine the services and support supervisees require and receive, including education, job training, and treatment?

Answer. In most cases, an offender's needs have been identified well before supervision begins, either at the pretrial or presentence stage of the Federal criminal justice system. The presentence report and the resulting sentencing document identify treatment, educational, employment, and other needs that will most likely have associated special conditions of the supervision term.

Following an offender's placement on probation or release from an institution, the probation officer works with the offender to assess the offender's risks, needs and strengths to prepare an individualized comprehensive supervision plan. Not all offenders require the same level of supervision to reach this goal. It is the officer's job to distinguish among them and to implement supervision strategies that are appropriately matched with the offender's risks, needs and strengths.

If substance abuse or mental health treatment conditions are ordered, the officer will either conduct an informed assessment or direct the person to undergo a clinical assessment performed by a professional treatment provider. If treatment is necessary, the officer refers the offender to a treatment program tailored to his needs. Treatment is part of the overall supervision objectives and strategies for the case. The officer monitors the offender's progress in treatment and collaborates with the treatment provider to further the offender's chances for success on supervision.

If education is identified as a need for an offender who never completed high school, the officer may identify obtainment of a GED as a supervision objective. If so, the officer assists the offender in enrolling in a local educational program. The officer continually monitors the offender's progress in this type of program, as well as in many others, intended to enhance the offender's success on supervision and beyond.

With respect to an unemployed or underemployed offender, federal probation officers are now working in partnership with the Bureau of Prisons, the Department of Labor and the National Institute of Corrections to create a systems approach to offender reentry and workforce development. Points of contact in each state have been identified to bring implementation of these partnerships to the local level. Probation and pretrial services officers have been trained as "offender workforce development specialists" in 36 states. Federal probation continues to expand the initiative by training more probation officers each year as offender employment specialists. Those trained then develop workforce development partnerships within their states and communities. Career fairs sponsored by Federal Probation for ex-offenders have been held in communities in each region of the country, and partnerships have been developed with colleges, one-stop centers, and community and faith-based organizations to provide resources and training for ex-offenders that provide career opportunities in occupations identified by the President's High Growth Jobs Initiative. This collaborative effort has reduced violations, revocations, and recidivism rates with respect to those who have participated in the employment initiative. Nearly 93 percent of those who start federal supervision employed are still employed at the time their cases close, a strong indicator that they have adapted to the community and are more likely to be successful after completing supervision.

If, during the period of supervision, an officer identifies educational, vocational or treatment needs for which there is no court-ordered special condition requiring the offender participation in the program(s), the officer will petition the court to modify the release conditions accordingly. A court-ordered special condition allows the officer to leverage sanctions if the offender does not comply with the condition. In many cases, the backing of the court will induce the offender to achieve the necessary skills and/or treatment necessary to succeed on supervision and beyond. All of the above interventions, in addition to individualized professional care and concern, contribute toward the goal of increasing the likelihood of success on supervision.

Question. Do you have any data on education levels of people under supervision and do you ensure that supervisees have opportunities to earn a GED if needed?

Answer. If education is identified as a need for an offender who never completed high school, the officer may identify obtainment of a GED as a supervision objective. If so, the officer assists the offender in enrolling in a local educational program. The officer continually monitors the offender's progress in this type of program, as well as in many others, intended to enhance the offender's success on supervision and beyond.

Data on education levels of people under supervision:

PERSONS RECEIVED FOR POST-CONVICTION SUPERVISION FOR THE 12 MONTH PERIOD ENDING 09/30/2007

Education Level	Number	Percent
No Formal Education	476	1
Some Elementary	1	.....
Elementary through 8th Grade	3,112	7
Some High School	12,581	27
Graduate Equivalency	7,123	15
Some Vocational School	9	.....

PERSONS RECEIVED FOR POST-CONVICTION SUPERVISION FOR THE 12 MONTH PERIOD ENDING 09/30/2007—Continued

Education Level	Number	Percent
Vocational School Graduate	441	1
High School Diploma	10,312	22
Some College	8,905	19
College Graduate	2,920	6
Post Graduate	643	1
Total	46,523	100

Modified Table E–1. Excludes pre-existing cases transferred between districts and cases where the education level was unavailable or not applicable.

JUDICIARY WORKLOAD

Question. The new bankruptcy legislation took effect in October 2005 and it appears that filings are still down from pre-Bankruptcy Act levels. From your testimony, it appears that you expect a significant increase in the number of bankruptcy filings—a 23 percent increase.

What trend do you expect in the future?

Answer. Following the implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) in October 2005, filings plummeted, falling roughly 50 percent from 1,484,570 filings in 2006 to 751,056 filings during 2007. The Judiciary's latest projections indicate that the number of petitions filed is expected to rise rapidly over the next two years, growing 23 percent in 2008 and another 13 percent in 2009. While, historically, there have been a handful of years where double-digit percentage increases have occurred, these 2008 and 2009 projections are still well below what would have been projected had BAPCPA not been enacted. The number of more work-intensive chapter 13 petitions is expected to reach pre-BAPCPA levels much sooner than the number of chapter 7 petitions.

Question. Will the current downturn in the economy likely further increase filings?

Answer. The Judiciary's bankruptcy filing projections assume that economic growth will be slow—but positive—and that consumer debt will remain high. If the economy worsens, filings would increase more rapidly in the near term. No consensus opinion exists regarding the degree to which a recession would affect overall filings.

Along with a slowing economy, a number of other factors indicate that filings could continue to grow at a fast pace, namely (1) the debt service burden is at or near record levels, (2) mortgage foreclosure rates have been rising, and (3) adjustable rate mortgage resets have made some monthly mortgage payments prohibitively expensive.

Passage and enactment of bankruptcy reform legislation currently under consideration in Congress, which would strike the current exemption of a mortgage on a debtor's principal residence, would likely result in a surge in chapter 13 filings.

Question. In your written testimony, you discussed the impact of the bankruptcy law passed by Congress in 2005. You wrote: "Our bankruptcy courts have indicated that the actual per-case work required of the bankruptcy courts has increased significantly under the new law." You also discussed the increased workload for debtors filing for bankruptcy under Chapter 7. Do you also agree that in the aftermath of the 2005 bankruptcy law there has also been an increased workload for bankruptcy trustees?

Answer. Yes, the workload for bankruptcy trustees has increased in the aftermath of the 2005 bankruptcy reform legislation. For example, a Chapter 7 case trustee must now review results of the debtor's means test, review extensive documentation provided by the debtor (pay stubs, mortgage documents, etc.), and provide the court a statement if the debtor's case is presumed to be abusive. The trustee must prosecute a motion to dismiss a case if substantial abuse of a Chapter 7 filing is discovered. There are also audit responsibilities for the case trustee to ensure that the debtor's schedules of income and expenses are accurate.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Your fiscal year 2009 budget submission does not request resources for additional staff in clerks and probation offices. Do you feel that you currently have the appropriate number of staff to address your workload?

Answer. Although the courts do not currently have the appropriate number of staff on board to address workload needs, the funding made available by Congress in fiscal year 2007 and fiscal year 2008 will allow the courts to narrow the gap between current staffing levels and workload. This funding will be utilized over a three year period—fiscal years 2007–2009—to increase staffing levels in the courts. In addition to the staff hired in fiscal year 2007, the Judiciary anticipates the courts will bring on another 305 FTE during fiscal years 2008 (150 FTE) and 2009 (155 FTE).

In fiscal year 2007, Congress provided the courts with $20.4 million to address the most critical workload needs. Because full-year funding was not made available to the courts until six months into the fiscal year, most of these new staff will be brought on board in fiscal year 2008. Hence, the $20.4 million was planned to be utilized during fiscal years 2007 and 2008. The fiscal year 2008 financial plan includes $15 million of the $20.4 million to hire 150 FTE to meet critical workload demands.

In fiscal year 2008, Congress provided the Judiciary with $25 million in emergency appropriations to address workload stemming from increased immigration enforcement. Of this amount, $14.5 million will be used to hire 155 FTE in clerks and probation offices, and the remaining $10.5 million provided for Defender Services will be used to pay private panel attorneys handling immigration cases. With the $14.5 million, the Judiciary estimates that the courts will bring on the 155 FTE over two years: 35 FTE in fiscal year 2008 and 120 FTE in fiscal year 2009.

Question. Please describe your current workload along the Southwest Border. Has the Judiciary been impacted by the additional law enforcement resources added to the border?

Answer.

Impact on the Federal Courts

The federal courts along the Southwest Border (SWB) have been impacted by additional law enforcement resources provided to the Department of Homeland Security (DHS) and the Department of Justice (DOJ) for border and immigration enforcement initiatives.

Criminal filings along the SWB increased 11 percent between 2002 and 2007, and filings in those five district courts currently account for nearly one-third of all criminal cases nationwide. The time sensitive nature of criminal cases, created by statutory issues involving speedy trials requirements, multiple hearings for defendants (e.g. initial appearances, arraignments, and pleas in the early stages), and the need for interpreter services, increase the courts' need for adequate staffing resources.

The SWB courts have the five highest number of felony defendants per judgeship and felony defendants along those five district courts currently account for nearly one-third of all felony defendants nationwide. In addition, the districts of Texas-Southern, New Mexico, and Texas-Western have experienced compounded growth rates in criminal caseload of 9.2 percent, 4.6 percent, and 9.1 percent, respectively, in the number of felony defendants from 2004 to 2007.

Pretrial caseload along the SWB has increased as well. From 2002 to 2007, the five SWB districts experienced a 28 percent increase in pretrial services cases activated compared to 8 percent growth nationally over the same period. By June 2007, the SWB districts accounted for 35 percent of all pretrial cases activated in the federal system.

In the probation program, SWB districts experienced a 10 percent increase in the number of supervision cases from 2002 to 2007. Nationally, the growth in post-conviction cases for that period was 7 percent. The five SWB district have consistently made up 13–14 percent of the total number of cases under post-conviction supervision in the federal system between 2002 and 2007.

While criminal case filings in the federal courts in the five judicial districts along the Southwest border is high by historical standards, filings have not increased commensurate with the increased resources provided to DHS for border enforcement. Despite zero tolerance border initiatives such as Operation Streamline in which nearly everyone apprehended for violating U.S. immigration laws is prosecuted, resource constraints in the justice system have precluded more cases from being prosecuted in the federal courts. Staffing shortages in U.S. Attorney offices, lack of detention beds needed to secure offenders awaiting prosecution, and staffing constraints in U.S. Marshals offices have resulted in the establishment of certain threshold levels in some border districts that must be met before a case is prosecuted. For example, a U.S. Attorney in one district may prosecute someone coming into the country illegally after the tenth attempt, while a U.S. Attorney in another district may prosecute after the fifth attempt.

More Resources Being Provided to the Border

The President's fiscal year 2009 budget includes $12 billion for DHS for border security and enforcement efforts, a 19 percent increase over fiscal year 2008, and a more than 150 percent increase since 2001. DHS has used the funding to increase the number of border patrol agents significantly, particularly on the Southwest border with Mexico. Since 2001, more than 5,000 additional border patrol agents have been hired with most of them placed along the Southwest border. In fiscal year 2008, DHS received funding to hire an additional 3,000 border patrol agents, and the President's fiscal year 2009 budget includes funding for another 2,200 agents, bringing the total to 20,000 agents. When fully staffed the Border Patrol will have more than doubled in size since 2001.

In fiscal year 2008 DOJ received $7 million in emergency funding to hire more assistant U.S. Attorneys (AUSAs) in the five judicial districts along the Southwest border. The U.S. Marshals Service received $15 million in emergency funding to address Southwest border workload needs including the hiring of 100 additional deputy U.S. Marshals. The President's fiscal year 2009 budget includes $100 million for a new Southwest Border Enforcement Initiative focusing law enforcement and prosecutorial efforts on fighting violent crime, gun smuggling, and drug trafficking in that region. If funded, this initiative will increase the number of AUSAs along the Southwest border by another 50 positions. The President's budget also seeks $88 million to expand detention capacity along the southwest border.

The resultant increase in criminal filings from this infusion of resources will impact district judges, clerks offices, probation and pretrial services offices, and federal defender offices on the border. The Judiciary's fiscal year 2009 budget submission, however, does not request funding for new clerks or probation or pretrial services staff on the border or elsewhere. Congress provided the Judiciary with $45.4 million over the last two years—$20.4 million in fiscal year 2007 and $25 million in fiscal year 2008—to address immigration-related workload so, from a staffing perspective, the courts are well positioned in the short term to respond to the increased workload that is expected to materialize.

Question. What additional actions is the Judiciary taking to reduce rent?

Answer. The fiscal year 2009 Judiciary budget request reflects lower requirements as a result of measures incorporated since the cost-containment strategy was initiated in fiscal year 2004. Specific examples of planned or ongoing initiatives that are helping the Judiciary manage costs, or will help in the future include: establishing an annual budget cap for GSA space rental costs for fiscal years 2009 through 2016, which limits annual growth by an average of 4.9 percent per year; revising the U.S. Courts Design Guide to lower future rental costs of space for chambers, attorneys, and court staff; validating GSA rent bills for each court facility and examining the GSA appraisal methodology to ensure rent charged is comparable to commercial rates; establishing "asset management planning" as the Judiciary's new long-range facilities planning methodology that will identify the most cost-effective strategy for meeting the court's operational needs, while controlling and containing costs, especially rent to GSA; and negotiating a return on investment pricing structure with GSA for all new space acquisitions, which replaces a market pricing approach.

Question. In particular, a GAO report identified several opportunities for the Judiciary to reduce its space usage and therefore its rent costs. What has the Judiciary done in response to that report?

Answer. Recommendation 1: Work with GSA to track rent and square footage trend data on an annual basis for the following factors: (1) rent component (shell rent, operations, tenant improvements, and other costs) and security (paid to the Department of Homeland Security); (2) judicial function (district, appeals, and bankruptcy); (3) rentable square footage; and (4) geographic location (circuit and district levels). This data will allow the Judiciary to create a better national understanding of the effect that local space management decisions have on rent and to identify any mistakes in GSA data.

Actions of the Judiciary:

—The Judiciary is continuing its efforts to obtain from GSA more specific information with regard to its rent bills that will aid the Judiciary in assigning costs to its various components. This effort has been quite time consuming as it requires GSA to remeasure its space and reclassify the information in GSA's database according to its type, e.g., district court courtrooms and chambers, clerk's office space, libraries, etc.

—The Judiciary is also continuing its national rent validation initiative to identify mistakes in GSA data. The program has been successful on a number of fronts. The Judiciary has received rent credits and long-term savings (cumulative savings over a 3-year period of over $50 million) and has benefited from GSA's improved internal management controls on its rent-setting practices. We antici-

pate receiving additional rent adjustments and credits resulting from over $10 million in rent errors that we recently reported to GSA. Additionally, the Judiciary (and GSA) now has in place a program to help ensure that accurate rent bills are sustained over the long term.

—As a follow-on to the base-line review of current rent bills, the Judiciary has embarked on a program to: (1) ensure future rent rates are appropriate; (2) maintain a website that will allow court personnel to determine quickly and easily the amount and cost of the space they occupy in federally owned facilities; and (3) design a training curriculum to provide court personnel with a comprehensive understanding of the rules, regulations, and procedures that govern the assignment, classification, and rental-rate determination for the space they occupy in federally owned facilities.

—On February 19, 2008, the Director of the Administrative Office and the Commissioner of GSA's Public Buildings Service signed a Memorandum of Agreement (MOA) that changes the way rent will be calculated for all federally owned courthouses to be delivered in the future. The MOA outlines a new process for determining rental rates based on a return on investment methodology. Under the MOA, the rent will be fixed for the first 20 years of occupancy and will be set to return to GSA approximately 7 percent per year of its capital costs; operating costs will be adjusted annually to reflect GSA's actual operating expenses. Both the Judiciary and GSA will benefit from knowing with certainty how much rent the Judiciary has to pay and how much rent GSA will receive.

Recommendation 2: Create incentives for districts/circuits to manage space more efficiently. These incentives could take several forms, such as a pilot project that charges rent to the circuits and/or districts to encourage more efficient space usage.

Actions of the Judiciary:

—In September of 2007, the Judicial Conference approved creation of the Circuit Rent Budget (CRB) program as part of the Judiciary's overall cost containment efforts. CRB is designed to promote greater fiscal discipline in the management of the Judiciary's use of space by aligning, at the circuit judicial council level, the budget responsibility for rent, with the authority to determine space need.

—The chief purpose of CRB is to enable the Judiciary to hold space cost growth to no more than 4.9 percent, on average, over the next eight years. The 4.9 percent cap on rent growth was approved by the Judicial Conference in September of 2006.

—In essence, CRB allocates rent funds to circuits to cover both existing space assignments as well as space growth, with space growth carefully limited through centralized approval of large projects, and by a formulaic distribution to individual circuits of authority to add to the rental base.

—Since its approval by the Judicial Conference in September 2007, the CRB program has been one of the Judiciary's main priorities in the space area. This initiative constitutes a dramatic change in the Judiciary's management of space and rent costs and its implementation affects virtually every work process and system currently in place.

—Now in its pilot year, CRB is transforming the way the Judiciary plans for and approves new space acquisitions. Numerous initiatives are in progress to make the CRB program fully functional and successful. Some of the initiatives include, but are not limited to: a major communications and training plan; and implementation and testing of updated procedures, forms, and processes. The automated system, the Judiciary's Facilities Asset and Construction System (JFACTS), is also being redesigned to support the re-engineering of the Judiciary's space and rent program.

Recommendation 3: Revise the Design Guide to: (1) establish criteria for the number of appeals courtrooms and chambers; (2) establish criteria for space allocated for senior district judges; and (3) make additional improvements to space allocation standards related to technological advancements (e.g., libraries, court reporter spaces, staff efficiency due to technology) and decrease requirements where appropriate.

Actions of the Judiciary:

—Over the last two years, the Judicial Conference of the United States approved multiple reductions to the space standards set forth in the U.S. Courts Design Guide that have reduced staff office sizes and chambers space for senior, district, appellate, bankruptcy and magistrate judges. In addition, the Committee on Space and Facilities plans to consider the criteria for the number of appeals courtrooms. Finally, the Judicial Conference approved technical amendments including reductions in atrium, lighting, and HVAC systems that will result in cost savings.

—As to the impact of electronic filing on court space, the Judiciary has reduced Design Guide requirements for some of the clerk's office space, including intake areas and records storage, because of the impact of the electronic case filing/case management system and has reduced the library space by 13 percent as a result of reductions in lawbook collections.

Question. More specifically, what is the Judiciary's stance on courtroom sharing?

Answer. The current Judicial Conference policy on courtroom sharing is that every active district judge, magistrate judge, and bankruptcy judge should have a courtroom. In response to an authorizing resolution passed by the House Committee on Transportation and Infrastructure, the Judiciary has instituted a policy of one courtroom for every two senior judges in all pending courthouse projects. All of the Judiciary's courtroom sharing policies for all types of judges are currently being studied by the Judicial Conference.

SUBCOMMITTEE RECESS

Senator DURBIN. The subcommittee will now stand in recess.

[Whereupon, at 4:33 p.m., Wednesday, March 12, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

WEDNESDAY, APRIL 16, 2008

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senator Durbin, Brownback, and Allard.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENT OF DOUGLAS SHULMAN, COMMISSIONER

ACCOMPANIED BY:

RICHARD SPIRES, DEPUTY COMMISSIONER
LINDA STIFF, DEPUTY COMMISSIONER

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. This hearing will come to order.

I am pleased to welcome you to this session before the Financial Services and General Government Appropriations Subcommittee. My colleagues will be joining me a little later on, and I will certainly welcome them.

Our focus today is on the President's fiscal year 2009 budget request for the Internal Revenue Service (IRS). It is a perfect day, is it not, the day after tax day?

Funding for the IRS alone constitutes just over one-half of the total amount requested by the administration for the nearly 30 agencies under this subcommittee's jurisdiction. Each year IRS employees make hundreds of millions of contacts with American taxpayers and businesses, and the IRS represents the face of Government to more U.S. citizens than any other agency.

Appearing before the subcommittee is a distinguished group of witnesses. They bring valuable expertise and public service experiences in their lives to this hearing today, and I appreciate it.

First, I am going to welcome Douglas Shulman, now in his fourth week—4 weeks now, Mr. Commissioner—as the 47th Commissioner of the Internal Revenue Service of the United States. Thank you for embarking on this challenge.

Joining us on the second panel will be three of IRS's key partners and watchdogs: J. Russell George, Treasury Inspector General for Tax Administration; Paul Cherecwich, Chairman of the IRS Oversight Board; and Nina Olson, National Taxpayer Advocate. I appreciate their work and look forward to their testimony.

PREPARED STATEMENT OF THE GOVERNMENT ACCOUNTABILITY OFFICE

I also want to acknowledge the helpful contributions of the Government Accountability Office (GAO) in response to our request for analysis. I welcome senior GAO officials: James R. White, Director of Strategic Issues, and David Powner, Director of Information Technology, Management Issues; and other members of their team. Their prepared statement will be a part of the record, and they stand ready to respond to questions.

[The statement follows:]

PREPARED STATEMENT OF JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE

INTERNAL REVENUE SERVICE: ASSESSMENT OF THE FISCAL YEAR 2009 BUDGET REQUEST

HIGHLIGHTS

Why GAO Did This Study

The fiscal year 2009 budget request for the Internal revenue Service (IRS) is a road map for how IRS plans to allocate resources and achieve ambitious goals for improving taxpayer service, increasing research, and continuing to invest in modernized information systems. One complicating factor in implementing IRS's plans in the immediate future is the recent passage of the Economic Stimulus Act of 2008, which creates additional, unanticipated workload for IRS.

GAO was asked to (1) assess how the President's budget request for IRS allocates resources and justifies proposed initiatives; (2) determine the status of IRS's efforts to develop and implement its Business Systems Modernization (BSM) program; and (3) determine the total costs of administering the economic stimulus legislation. To meet these objectives, GAO drew upon and updated recently issued reports.

What GAO Recommends

GAO is not making new recommendations, but the statement highlights outstanding recommendations to extend the use of return on investment (ROI) analysis to cover major enforcement programs and improve BSM management controls and capabilities.

What GAO Found

The President's fiscal year 2009 budget request for IRS is $11.4 billion, 4.3 percent more than last year's enacted amount. The request proposes to maintain taxpayer service at recent levels, in part by realizing efficiency gains from electronic filing, despite a decrease in staffing. It also proposes a 7 percent increase in enforcement spending, including spending for 21 legislative and nonlegislative initiatives. The legislative proposals are projected to cost $23 million in fiscal year 2009, funding that IRS would not need if the proposals are not enacted. Similarly, if IRS were to fall behind in its proposed enforcement hiring efforts, it would not need all $226 million of the associated funding. IRS justified its nonlegislative enforcement initiatives with ROI analyses, which are useful, despite limitations, for making resource allocation decisions. The budget request does not provide ROI information for activities that constitute a large part of the budget request—activities other than the proposed initiatives.

The request for BSM is over $44 million lower than the fiscal year 2008 enacted amount. IRS said this funding level will allow it to continue its primary modernization projects, but it did not describe how specific projects or benefits to taxpayers would be affected. IRS has continued to make progress in implementing BSM projects and improving modernization management controls and capabilities. However, further improvements are needed. For example, the agency has yet to develop long-term plans for completing BSM and consolidating and retiring legacy systems.

IRS estimated that the costs of implementing the economic stimulus legislation may be up to a total of $767 million—including a $202 million supplemental appropriation. In addition to the supplemental appropriation, IRS is reallocating hundreds of collections staff to answering taxpayer telephone calls, resulting in up to $565 million in foregone enforcement revenue. In addition, IRS expects some deterioration in telephone service because of the increased call volume. For example, IRS is expecting its assistor level of service to drop to as low as 74 percent compared to its goal of 82 percent.

THE PRESIDENT'S FISCAL YEAR 2009 REQUEST FOR IRS FULL-TIME EQUIVALENTS (FTES) COMPARED TO FISCAL YEAR 2008 ENACTED BUDGET FTES

Appropriation	Fiscal year 2008 enacted	Fiscal year 2009 requested	Percentage change
Enforcement	47,349	49,792	+5.2
Taxpayer Service	31,218	30,792	−1.4
Operations Support	12,181	11,989	−1.6
BSM	358	333	−7.0
Health Insurance Tax Credit	17	16	−5.9
Total	91,123	92,922	+2.0

Source: GAO analysis of IRS data.

Mr. Chairman and Members of the Subcommittee: We appreciate this opportunity to comment on the President's fiscal year 2009 budget request for the Internal Revenue Service (IRS).

Financing of the Federal Government depends largely on IRS's ability to effectively administer the tax laws. The President has requested $11.4 billion in program dollars to fund IRS's fiscal year 2009 operations, including $11.1 billion for service to taxpayers and tax law enforcement, plus $223 million for the BSM program, IRS's ongoing effort to improve the agency's business and tax processing systems.

The fiscal year 2009 budget request is a road map for how IRS intends to allocate resources in order to carry out ambitious plans of improving enforcement, improving taxpayer service, increasing research, and continuing to invest in modernized information systems. Together with the budget request, IRS's recently published strategies spell out its intentions for improving taxpayer service and reducing the net tax gap—the difference between the taxes owed and eventually paid, most recently estimated at $290 billion for tax year 2001.[1] The budget request and strategies aim to build on recent IRS accomplishments such as annually bringing in more revenue through enforcement and making progress on modernizing IRS's business and tax processing systems. One complicating factor for carrying out IRS's ambitious plans in the immediate future is the recent passage of the Economic Stimulus Act of 2008, which creates additional, unanticipated workload for IRS this year.[2] Passage of this act required IRS to act quickly to deal with taxpayers' questions and begin issuing payments.

Based on your request, our objectives were to (1) assess how the President's budget request for IRS for fiscal year 2009 allocates resources for enforcement, service, research, and systems modernization primarily compared to fiscal year 2008 enacted levels; (2) assess the rationales for differences between the 2 years, including the rationales for initiatives and the extent to which those rationales have been justified; (3) determine the status of IRS's efforts to develop and implement its BSM program; and (4) determine the total cost of administering the economic stimulus program.

To meet these objectives, we drew upon and updated a recently issued report on the budget request and IRS's 2008 tax filing season, and for our BSM work, we relied primarily on our review of the fiscal year 2008 BSM expenditure plan.[3] For the first report, we compared enacted and requested budgets for IRS; reviewed documents, including estimates of revenues and costs from initiatives; and interviewed

[1] Internal Revenue Service, *Reducing the Federal Tax Gap* (Washington, D.C.: Aug. 2, 2007); and Internal Revenue Service, *The 2007 Taxpayer Assistance Blueprint* (Washington, D.C.: 2007).

[2] Pub. L. No. 110–185 (2008).

[3] GAO, *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, GAO–08–567 (Washington, D.C.: Mar. 13, 2008) and GAO, *Business Systems Modernization: Internal Revenue Service's FISCAL Year 2008 Expenditure Plan*, GAO–08–420 (Washington, D.C.: Mar. 7, 2008).

IRS officials. For our BSM report, we analyzed the expenditure plan, reviewed other documents, and interviewed IRS officials. In assessing the cost of the economic stimulus package, we obtained performance and production data, looking for factors that significantly affected performance, and we interviewed IRS officials. We conducted the current performance audit from March 2008 through April 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. For a more detailed discussion of our scope and methodology, see the appropriate sections in the budget and filing season and the BSM reports.

In summary, we make the following major points:

—The President's budget request for IRS proposes to maintain taxpayer service at recent levels and increase enforcement. Overall, it increases spending on IRS by 4.3 percent. Spending on taxpayer service would increase by less than 1 percent, which would result in reduced staffing, but the level of taxpayer service would be maintained by realizing efficiency gains, in part, through increases in electronic filing. The budget proposes a 7 percent increase in enforcement spending, including funds and staffing for various legislative and nonlegislative initiatives. According to the proposal, the legislative initiatives would raise about $36 billion in revenue over 10 years. They are projected to cost $23 million in fiscal year 2009, funding IRS would not need if none of the legislative initiatives were enacted. Similarly, if IRS were to fall behind in meeting its challenging hiring goals for the nonlegislative initiatives, it would not need all $226 million of the associated funding for fiscal year 2009.

—IRS included more information than past years on the initiatives in the fiscal year 2009 proposed budget. Of particular note, IRS included return on investment (ROI) information for all nonlegislative initiatives. However, beyond those initiatives, the budget request does not provide an analytic basis for key resource allocation decisions. Such decisions include allocating resources among a variety of enforcement programs and taxpayer services. Analytic data such as ROI can be helpful to IRS's management and the Congress for making these decisions as well as decisions about the overall balance between taxpayer service and enforcement. Although the budget request provides performance measure data, it does not provide ROI for programs or activities that constitute a large part of the budget request—activities other than the proposed initiatives.

—The requested budget for BSM is over $44 million lower than the fiscal year 2008 enacted amount of about $267 million and roughly $185 million less than the amount the IRS Oversight Board is proposing. Modernized e-File (MeF) is the project with the largest difference between the requested budget and the fiscal year 2008 enacted amount. IRS stated that the requested BSM funding level will allow it to continue developing and delivering its primary modernization projects but did not provide details on how plans to deliver specific projects or benefits to taxpayers would be affected. IRS continues to make progress in implementing BSM projects and meeting cost and schedule commitments for most deliverables, but three project milestones recently experienced significant cost or schedule delays.[4] IRS has also taken steps to address our prior recommendations; however, work remains to fully implement them, including developing long-term plans for completing the BSM program. Future releases of the Customer Account Data Engine (CADE) and Account Management Services (AMS) continue to face risks and challenges, which IRS is working to mitigate. Finally, we recently recommended that IRS complete a plan with specific time frames for implementing initiatives supporting its information technology (IT) human capital strategy, and IRS agreed.

—IRS estimates that the cost of implementing the economic stimulus legislation may be up to a total of $767 million, including a $202 million supplemental appropriation. In addition to the supplemental appropriation, IRS is reallocating resources from enforcement to taxpayer service by shifting hundreds of collections staff to answering telephone calls and, as a result, may forego up to $565 million in enforcement revenue. IRS has experienced a deterioration of telephone access and expects a further decline. For example, IRS's assistor level of service—which measures a taxpayer's ability to get through and speak to an assistor—has already declined, and IRS expects access to continue to drop to as low as 74 percent, down from the fiscal year 2008 goal of 82 percent.

[4] Milestones represent different phases in IRS's project life cycle.

THE FISCAL YEAR 2009 BUDGET REQUEST PROPOSES TO MAINTAIN TAXPAYER SERVICE AT RECENT LEVELS AND INCREASE ENFORCEMENT

The President's budget request is proposing to maintain taxpayer service levels with fewer staff by realizing efficiency gains; it also proposes to increase enforcement by adding staff. The President's fiscal year 2009 budget request of $11.4 billion for IRS is 4.3 percent more than the fiscal year 2008 enacted budget and represents an increase of less than 1 percent for taxpayer service and 7 percent for enforcement, as shown in table 1.

TABLE 1.—THE PRESIDENT'S FISCAL YEAR 2009 REQUEST FOR IRS COMPARED TO THE FISCAL YEAR 2008 ENACTED BUDGET

[Dollars in thousands]

Program	Fiscal year 2008 enacted	Fiscal year 2009 requested	Percentage change
Enforcement	$6,997,226	$7,487,209	+7.0
Taxpayer Service	3,612,833	3,636,230	+0.6
BSM	267,090	222,664	−16.6
Health Insurance Tax Credit	15,235	15,406	+1.1
Total	10,892,384	11,361,509	+4.3

Note: Dollar amounts include amounts for operations support.

Source: GAO analysis of IRS data.

The budget request increases IRS-wide staff levels, measured in full-time equivalents (FTEs), by 2 percent, with a 1.4 percent decrease in taxpayer service FTEs and a 5.2 percent increase in enforcement FTEs, as shown in table 2.

TABLE 2.—THE PRESIDENT'S FISCAL YEAR 2009 REQUEST FOR IRS FTES COMPARED TO FISCAL YEAR 2008 ENACTED BUDGET FTES

Appropriation	Fiscal year 2008 enacted	Fiscal year 2009 requested	Percentage change
Enforcement	47,349	49,792	+5.2
Taxpayer Service	31,218	30,792	−1.4
Operations Support	12,181	11,989	−1.6
BSM	358	333	−7.0
Health Insurance Tax Credit	17	16	−5.9
Total	91,123	92,922	+2.0

Note: The decline in taxpayer services, including operations support, reflects 91 FTEs in efficiency savings and 207 FTEs in electronic filing savings. The increase in enforcement, including operations support, includes an additional 1,431 revenue agents and 582 revenue officers who will work on initiatives.

Source: GAO analysis of IRS data.

The President's budget proposal is consistent with longer-term trends for IRS. Compared to actual spending in fiscal year 2006, the proposed fiscal year 2009 budget increases taxpayer service funding by 3.7 percent, a real decrease after inflation, while increasing IRS's enforcement funding by 10 percent.

The budget request proposes to maintain taxpayer service at recent levels. As an example, the key taxpayer service measures shown in table 3 are projected to remain relatively stable through fiscal year 2009.

TABLE 3.—TELEPHONE SERVICE MEASURES

[In percent]

Measure	Fiscal year 2006 actual	Fiscal year 2007 actual	Fiscal year 2008 planned	Fiscal year 2009 planned
Telephone performance—access: Assistor level of service (percentage of taxpayers who wanted to talk with an assistor and actually got through and received service)	82.0	82.1	82.0	82.0

TABLE 3.—TELEPHONE SERVICE MEASURES—Continued

[In percent]

Measure	Fiscal year 2006 actual	Fiscal year 2007 actual	Fiscal year 2008 planned	Fiscal year 2009 planned
Telephone performance—accuracy:				
Tax law customer accuracy (percentage of calls in which telephone assistors provided accurate answers on tax law and took appropriate action)	90.9	91.2	91.0	91.0
Accounts customer accuracy (percentage of calls in which telephone assistors provided accurate answers on customer accounts and took appropriate action)	93.2	93.4	93.5	93.7

Source: GAO analysis of IRS data.

In order to maintain taxpayer service at recent levels despite a decrease in real spending and staffing, IRS expects to realize efficiency gains. For instance, IRS expects to devote 207 fewer FTEs to the labor-intensive processing of paper returns because of expected increases in electronic filing. These expected efficiency gains are consistent with past trends—between 1999 and 2007, IRS reduced staff devoted to processing paper returns by about 1,800 FTEs.

IRS's ability to maintain or improve taxpayer service beyond 2009 will likely depend on its ability to continue to improve efficiency. To this end, in recent reports, we made recommendations to further increase electronic filing. We recommended that IRS determine the actions needed to require software vendors to include bar codes on printed returns, and we suggested that the Congress mandate electronic filing by certain paid tax preparers.[5] IRS agreed with our bar code recommendation and outlined the actions it would take.

Some of the real spending decrease proposed for fiscal year 2009 is because of one-time investments made in fiscal year 2008 or carryovers in funds from fiscal year 2008. For instance, the budget request proposes a $31 million reduction in funding for taxpayer assistance centers and outreach. However, IRS officials told us that this reduction includes funding used for long-term investments in fiscal year 2008 that would not need to be duplicated in fiscal year 2009. IRS officials also told us that a $7.7 million decrease in funding for the Taxpayer Advocate offsets a funding increase in fiscal year 2008 that is being used to lower the Advocate's outstanding caseload. Finally, an $8 million reduction in the Volunteer Income Tax Assistance (VITA) program reflects fiscal year 2008 funding that was not spent and carried over into fiscal year 2009.[6]

The budget request for IRS's enforcement programs includes nonlegislative and legislative initiatives. According to the proposal, the five nonlegislative enforcement initiatives would cost about $338 million in fiscal year 2009 and are expected to raise about $2 billion of direct revenue annually starting in fiscal year 2011.[7] In addition, the budget request estimates that the enforcement initiatives would generate at least another $6 billion annually in indirect revenue. The indirect revenue results from improved voluntary compliance induced by taxpayers' awareness of expanded IRS enforcement. The budget request also proposes increases in examination coverage for corporations with assets of $10 million or more from a planned 6.6 percent for fiscal year 2008 to 6.8 percent for fiscal year 2009. The coverage rate would in-

[5] GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated*, GAO–08–38 (Washington, D.C.: Nov. 15, 2007) and GAO, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, GAO–07–27 (Washington, D.C.: Nov. 15, 2006).

[6] The funding provided in fiscal year 2008 was 2-year funding. Since IRS was ramping up the program being funded—providing matching grants to volunteer preparer organizations—in 2008, additional funding was not needed for 2009. Despite not asking for additional funding, IRS is expecting to see large, but unquantified, growth in tax returns prepared at VITA sites. According to IRS officials, IRS does not have a separate line item showing how much it spent on VITA overall.

[7] These nonlegislative initiatives involve (1) reducing the tax gap for small businesses and the self-employed; (2) reducing it for large businesses; (3) increasing reporting compliance related to offshore activity; (4) through research, improving tax gap estimates, measurement, and detection of noncompliance; and (5) expanding document matching.

crease to 7.6 percent in fiscal year 2010 as new enforcement staff hired in fiscal year 2009 complete training and can audit more returns.

The budget request includes 16 legislative initiatives budgeted at $23 million for fiscal year 2009 that it says would raise about $36 billion in revenue over 10 years; if none were enacted, IRS would not need the $23 million. We have reported on three of the proposals. In 2006, we suggested that the Congress consider an idea for reducing securities capital gains noncompliance.[8] In 1991, we supported the notion that payments to corporations be reported on information returns.[9] Finally, in 2007, we described ways to mitigate the compliance costs related to these information returns and to other information returns associated with credit and debit card payments.[10]

The revenue expected from IRS's enforcement initiatives is modest compared to the net tax gap, which was last estimated at $290 billion for tax year 2001. As we noted in our statement to this Committee last year, no single approach, such as IRS enforcement, is likely to fully and effectively address noncompliance.[11] Multiple approaches are needed because noncompliance has multiple causes and spans different types of taxes and taxpayers.

Hiring needed staff for the nonlegislative initiatives will be challenging for IRS's Large and Mid-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) divisions. For instance, the initiatives call for adding 1,431 revenue agents in addition to those who must be replaced from attrition, a high number relative to past years. IRS divisions have previously hired large numbers of staff in a short time because of specific budget initiatives, but officials reported that hiring gradually over time would reduce challenges. If IRS were to fall behind in its hiring efforts, it would not need all $226 million of the funding for staff for fiscal year 2009 initiatives.

IRS HAS ENHANCED ITS JUSTIFICATIONS FOR INITIATIVES AND COULD BENEFIT FROM USING ROI ANALYSES MORE BROADLY, EVEN WITH THEIR LIMITATIONS

Responding to our recommendations from last year, IRS included more information on initiatives in the fiscal year 2009 proposed budget, including ROI information for all nonlegislative initiatives. Last year, we recommended that IRS have available basic descriptive, cost, and expected performance information on all new initiatives and include such information in future budget submissions.[12] This year, the budget request has sections explicitly entitled, for instance, "Initiative Summary," "Implementation Plan," "Expected Benefits," and "ROI." Four of the five nonlegislative enforcement initiatives for fiscal year 2009 were revisions of fiscal year 2008 initiatives, but with more total funds requested and generally more informative justifications than for fiscal year 2008.

However, IRS's ROI calculations have limitations that reflect the challenges of estimating ROIs. For example, the calculations do not account for benefits that are harder to measure, such as improved voluntary compliance. Another example showing ROI limitations is the $51 million National Research Project (NRP) initiative for which IRS estimates the ROI to be $0.40 per $1.00 invested. NRP funds research audits in order to develop more effective enforcement programs. The ROI calculation only includes direct revenue resulting from the research audits, not the potential for increased revenue from improved enforcement programs; nor does the calculation include the benefits of the Department of the Treasury's use of NRP data to provide the basis for legislative recommendations.

Although the budget request for IRS provides performance measure data, it does not provide ROI analyses for programs or activities other than the new initiatives. As we noted in our recent report, analytic data such as ROI can be helpful to managers and the Congress when making resource allocation decisions.[13] ROI analyses, even with their limitations, can help answer questions such as the following:

—What are the implications for IRS's resource allocation of the lower costs per taxpayer contact for some services compared to others as shown in table 4?

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[8] GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO–06–603 (Washington, D.C.: June 13, 2006).

[9] GAO, *Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs*, GAO/GGD–91–118 (Washington, D.C.: Sept. 27, 1991).

[10] GAO, *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO–08–266 (Washington, D.C.: Nov. 20, 2007).

[11] GAO, *Internal Revenue Service: Assessment of the 2008 Budget Request and an Update of 2007 Performance*, GAO–07–719T (Washington, D.C.: May 9, 2007).

[12] GAO–07–719T.

[13] GAO–08–567.

—Are there extra benefits that offset the higher costs of some services, or could costs be reduced by promoting increased reliance on the lower-cost options?

TABLE 4.—COST OF PROVIDING TAXPAYER SERVICE IN FISCAL YEAR 2005

Service	Estimated cost per contact
Answering tax law questions via e-mail	$52.51
Providing assistance at taxpayer assistance centers	28.73
Answering correspondence	24.97
Providing assistance by assistors via toll-free telephones	19.46
Providing assistance through VITA sites	12.01
Providing assistance by automation via toll-free telephones	0.71
Providing assistance such as downloads and searches on IRS's Web site	0.13

Note: IRS reported that these estimates do not fully allocate all indirect overhead and support costs. We have reported that because of long-standing limitations in IRS's cost accounting capability, cost data at this detailed level have not been audited (see, for example, GAO–07–310 and 07–247). From our perspective, it would be important to know more about the indirect and support costs to see if they might significantly change the cost estimates.

Source: GAO analysis of IRS data.

Similar questions can be asked about enforcement based on table 5:

—Is IRS appropriately allocating resources between field audits, often conducted at a taxpayer's business, and correspondence audits, which are simpler and conducted by mail? [14]

—For the rows in table 5 with average recommended additional tax per return greater for correspondence audits than for field audits, could resources be reallocated from field audits to correspondence audits in order to help close the tax gap?

—Are there other benefits to field audits, such as a greater impact on voluntary compliance, that are not captured in IRS's data?

TABLE 5.—FIELD AND CORRESPONDENCE AUDITS OF SOME BUSINESS CATEGORIES OF TAXABLE INDIVIDUAL INCOME TAX RETURNS, FISCAL YEARS 2006 AND 2007

Type and size of return	Number of returns examined		Average recommended additional tax per return	
	Field	Correspondence	Field	Correspondence
Fiscal year 2006:				
Business nonfarm returns by size of total gross receipts (TGR):				
Under $25,000	19,801	107,802	$3,918	$2,614
$25,000 under $100,000	38,722	42,070	5,464	7,600
$100,000 or more	54,716	34,515	25,787	27,863
Fiscal year 2007:				
Business nonfarm returns without earned income tax credit, by size of TGR:				
Under $25,000	53,092	81,237	4,836	11,048
$25,000 under $100,000	31,363	31,513	6,320	11,793
$100,000 under $200,000	28,286	28,041	24,582	32,640
$200,000 or more	11,319	1,730	15,959	7,017
Business returns with total positive income at least $200,000 and under $1 million	17,499	15,280	20,880	33,406

Note: This table does not include all categories of audits. For a number of those categories, field audits produce a higher average recommended additional tax per return than do correspondence audits.

Source: GAO analysis of IRS data.

We recognize that developing ROI estimates for IRS's ongoing programs such as examinations and taxpayer service will be a challenge. However, because of the potential benefits of ROI analyses, we recommended in our previous report on the fiscal year 2009 budget request that the Commissioner of Internal Revenue extend the use of ROI in future budget proposals to cover major enforcement programs. At that time, IRS officials said that because of the short time frame for our report, they did

[14] In fiscal year 2007 correspondence audits took, on average, 1.4 hours to conduct compared to the 30.8-hour average for field audits done at taxpayers' locations and the 7.8-hour average for field audits done at IRS offices.

not have time to fully analyze its recommendations, and, therefore, were unable to respond.[15] We have agreed to meet with IRS to further discuss the ROI recommendation.

FURTHER PROGRESS MADE IN IMPLEMENTING BSM, BUT CHALLENGES AND RISKS REMAIN

IRS's BSM program, initiated in 1999, involves the development and delivery of a number of modernized tax administration, internal management, and core infrastructure projects that are intended to provide improved and expanded service to taxpayers as well as IRS internal business efficiencies. Key tax administration projects include CADE, which is intended to provide the modernized database foundation to replace the existing Individual Master File processing system that contains the repository of individual taxpayer information; AMS, which is intended to enhance CADE by providing applications for IRS employees and taxpayers to access, validate, and update accounts on demand; and MeF, which is to provide a single standard for filing electronic tax returns. We recently reported that while IRS has continued to make progress in implementing BSM projects and improving modernization management controls and capabilities, challenges and risks remain, and further improvements are needed.[16]

As shown in table 6, the fiscal year 2009 budget request for the BSM program is less than the enacted fiscal year 2008 budget by over $44 million and about $185 million less than the amount the IRS Oversight Board is proposing. When we asked about the impact of this reduction on its operations, IRS told us that the proposed funding level will allow it to continue developing and delivering its primary modernization projects but did not provide details on how plans to deliver specific projects or benefits to taxpayers would be affected. MeF is the project with the largest difference between the requested budget and the fiscal year 2008 enacted amount.

TABLE 6.—BSM FUNDING DIFFERENCES, FISCAL YEAR 2008 AND 2009

[In thousands of dollars]

Project	Fiscal year 2008 enacted	Fiscal year 2009 budget request
Customer Account Data Engine	58,500	58,800
Accounts Management Services	28,983	26,158
Modernized e-File	55,802	25,000
Filing & Payment Compliance	.....	.....
Core Infrastructure	39,150	32,000
Architecture, Integration, and Management	35,100	35,000
Management Reserve	4,310	2,300
Subtotal Capital Investments	221,845	179,258
BSM Labor	44,000	42,052
Subtotal Program Request	265,845	221,310
Maintaining Current Levels	1,245	1,354
Total BSM Budget Request	267,090	222,664

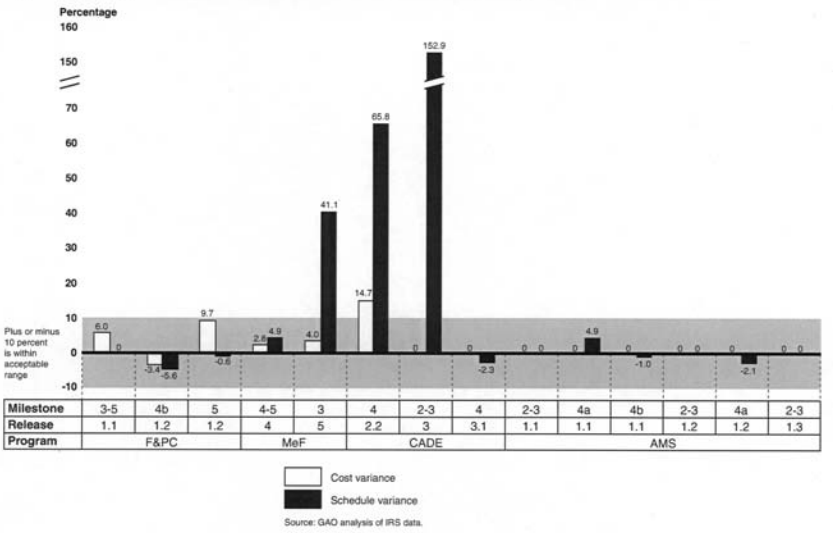
Source: IRS data.

IRS has made progress in implementing BSM projects and meeting cost and schedule commitments for most deliverables, but three project milestones experienced significant cost or schedule delays.[17] During 2007, IRS completed milestones of the Filing and Payment Compliance (F&PC), a tax collection case analysis support system; MeF; CADE; and AMS. Our analysis of reported project costs and completion dates showed that 13 of the 14 associated project milestones that were scheduled for completion during this time were completed within 10 percent of cost estimates, and 11 of the 14 milestones were completed within 10 percent of schedule estimates. However, a milestone for CADE exceeded its planned schedule by 66 percent and experienced a 15 percent cost increase; another milestone for the same

[15] GAO–08–567.
[16] GAO–08–420.
[17] Milestones represent different phases in IRS's project life cycle.

project incurred a 153 percent schedule delay, and a milestone for MeF experienced a 41 percent schedule delay (see fig. 1).

Figure 1: Summary of Cost and Schedule Performance for Fiscal Year 2007 Project Milestones



IRS has taken steps to address our prior recommendations to improve its modernization management controls and capabilities. However, work remains to fully implement them. For example, in July 2005, we recommended that IRS fully revisit the vision and strategy for the BSM program and develop a new set of long-term goals, strategies, and plans consistent with the budgetary outlook and IRS's management capabilities.[18] We also noted that the vision and strategy should include time frames for consolidating and retiring legacy systems. In response, IRS has developed a Modernization Vision and Strategy framework and supporting 5-year Enterprise Transition Plan. However, the agency has yet to develop long-term plans for completing BSM and consolidating and retiring legacy systems. We also recommended in February 2007 that IRS ensure that future BSM expenditure plans include a quantitative measure of progress in meeting scope expectations.[19] We further recommended that, in developing this measure, IRS consider using earned value management since this is a proven technique required by the Office of Management and Budget for measuring cost, schedule, and functional performance against plans.[20] While IRS has developed an approach to address our recommendation, it has not yet fully implemented it.

Future BSM project releases continue to face significant risks and issues, which IRS is addressing. Specifically, the agency recently identified significant risks and issues with planned system deliveries of CADE and AMS and reported that maintaining alignment between the two systems will be a significant challenge and source of risk for the BSM program. IRS recognizes the potential impact of identified risks and issues on its ability to deliver projects within cost and schedule estimates and has developed mitigation strategies to address them. While mitigation strategies have been developed, the risks and challenges confronting future releases of CADE and AMS are nevertheless significant, and we will continue to monitor them and actions to address them.

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[18] GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2005 Expenditure Plan*, GAO–05–774 (Washington, D.C.: July 22, 2005).

[19] GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2007 Expenditure Plan*, GAO–07–247 (Washington, D.C.: Feb. 15, 2007).

[20] Earned value management is a project management tool that integrates the investment scope of work with schedule and cost elements for investment planning and control. This method compares the value of work accomplished during a given period with that of the work expected in the period. Differences between accomplishments and expectations are measured in both cost and schedule variances.

IRS also made further progress in addressing high-priority BSM program improvement initiatives during the past year. In September 2007, IRS completed another cycle of initiatives and initiated a new cycle, which was scheduled to be completed at the end of March 2008. Initiatives that were addressed in the 6-month cycle ending in September 2007 included IT human capital, information security, and process improvements (e.g., developing and implementing standardized earned value management practices for major projects). IRS's program improvement process continues to be an effective means of regularly assessing, prioritizing, and incrementally addressing BSM issues and challenges. However, more work remains for the agency to fully address these issues and challenges.

Finally, we recently reported that efforts to address human capital challenges continue, but more work remains. IRS developed an IT human capital strategy that addresses hiring critical personnel, employee training, leadership development, and workforce retention, and agency officials stated that they plan to undertake a number of human capital initiatives to support their human capital strategy, including conducting analyses of turnover rates and continuing efforts to replace key leaders lost to retirement. However, a specific plan with time frames for implementing these initiatives has not been developed. We recommended that IRS complete such a plan to help guide the agency's efforts in addressing its IT human capital gaps and measure progress in implementing them. IRS agreed with our recommendation and stated that it intends to develop a plan to implement its IT human capital strategy.

IRS ESTIMATES THE COST OF IMPLEMENTING THE ECONOMIC STIMULUS LEGISLATION MAY BE UP TO A TOTAL OF $767 MILLION AND EXPECTS DECLINES IN SOME TAXPAYER SERVICES

The Economic Stimulus Act of 2008 is resulting in a significant workload increase not anticipated in the fiscal year 2008 budget. As part of the legislation, IRS received $202 million in a supplemental appropriation. However, because IRS could not find an alternative according to responsible officials, it has reallocated resources from enforcement to taxpayer service and is allowing some deterioration in telephone service.

IRS will begin sending economic stimulus payments to more than 130 million households in early May, after the current tax filing season, and is scheduled to be done by mid-July. These include an estimated 20 million retirees and disabled veterans, and low-wage workers who usually are exempt from filing a tax return but will be eligible for stimulus payments. Taxpayers required to file a tax return must do so by April 15 in order to receive a stimulus payment by mid-July.[21] People who are not required to file a tax return, but are doing so to receive a stimulus payment, are required to file an IRS Form 1040A by October 15, 2008.

As part of the legislation, IRS received a supplemental appropriation of $202 million to help fund its costs for implementing the stimulus package. This funding will remain available until September 30, 2009. As shown in table 7, IRS plans to spend the bulk of the funding—$151.4 million—for Operations Support, most of it on postage for two mass mailings and on IT support. IRS also expects to spend $50.7 million for Taxpayer Services, including $26.2 million for staffing and overtime for telephone assistors. IRS is expecting 2.4 million additional telephone calls in March and April with questions for IRS assistors about the economic stimulus legislation. These calls are in addition to the more than 14 million calls typically answered by IRS assistors between January and mid-April.

TABLE 7.—IRS'S ESTIMATED COSTS OF IMPLEMENTING THE ECONOMIC STIMULUS LEGISLATION

[Dollars in millions]

	2008 goal	Revised estimate	Amount
Supplemental appropriation:			
Operations Support:			
Postage			$90.613
IT support			$43.965
Telecommunications			$8.370
Printing			$6.767
Communications plan			$1.700

[21] Taxpayers who are unable to meet the April 15 filing deadline can file a Form 4868, the automatic extension of time to file, which gives them until October 15 to submit a 2007 tax return.

TABLE 7.—IRS'S ESTIMATED COSTS OF IMPLEMENTING THE ECONOMIC STIMULUS LEGISLATION—Continued

[Dollars in millions]

	2008 goal	Revised estimate	Amount
Total for Operations Support			$151.415
Taxpayer Services: Additional staffing/overtime			$50.720
Total supplemental funding			$202.135
IRS estimates of foregone revenue from shifting Automated Collection System (ACS) staff: [1]			
Wage and Investment (W&I)			$191.728
Small Business/Self-Employed (SB/SE)			$373.065
Total foregone revenue (up to)			$564.793
Total (up to)			$766.928
Taxpayer service: Assistor level of service (percent)	82	(2)	(3)

[1] Revised as of early April 2008.
[2] As low as 74.
[3] Reduction—Down 8 percentage points.

Source: GAO analysis of IRS and Treasury data.

To help meet the increased telephone demand, IRS is shifting about half of its over 2,000 Automated Collection System (ACS) telephone staff from collecting delinquent taxes to answering economic stimulus telephone calls from March through May.[22] To accommodate this shift, IRS stopped sending out some ACS-generated notices, such as notices of levy, several weeks ago.[23] According to IRS officials, it takes about 3 to 4 weeks before this adjustment in ACS-generated notices affects the ACS workload. IRS originally estimated that the revenue foregone by shifting ACS staff to be up to $681 million. However, according to IRS officials, in early April, IRS revised its foregone revenue estimate down to $565 million, shown in table 7, largely because of lower-than-expected demand for telephone assistance in March.[24]

According to IRS officials, IRS's priority is to respond to taxpayers' questions about the stimulus program; therefore, the officials are monitoring call volume and adjusting the number of ACS staff answering telephones accordingly. When call volume is low, ACS staff work on outstanding ACS collection cases. However, IRS officials stated that this work does not produce the same revenue as the ACS-generated notices, particularly revenue generated from notices of levy. When IRS adjusts the volume of ACS-generated notices, it takes several weeks before that adjustment affects ACS workload. IRS officials do not want to resume sending ACS-generated notices until they are sure ACS staffers are available to handle the resulting workload.

Should the lower-than-expected call volume continue, IRS may have an opportunity to shift the ACS staff back to their most productive collection work. This could further reduce the revenue foregone from using ACS staff to answer stimulus-related telephone calls. To date, IRS has not reduced its projections for future stimulus-related call volume. If the projections are reduced, IRS may be able to resume sending out at least some ACS-generated notices.

According to IRS officials, IRS considered alternatives to shifting ACS staff, including contracting out, using other IRS staff, or using Social Security Administration or other Federal staff, but decided the alternatives were not feasible. For example, contracting out was not deemed feasible because of insufficient time to negotiate the contract and conduct background checks and training.

[22] When IRS has completed sending its initial series of notices to tax debtors, it assigns the debts to its collections programs, such as ACS. ACS is an automated telephone-based system designed to call tax debtors. ACS staffers then attempt to talk with tax debtors to try to collect outstanding tax debt. IRS estimated there are about 1,200 ACS staff in its W&I division and about 1,100 in its SB/SE division.

[23] IRS suspended notices sent by ACS examiners, such as final notices before enforcement, collection due process notices, and notices of levy.

[24] IRS arrived at the estimates by taking a 3-year average of dollars collected by closing ACS cases for both its W&I and SB/SE divisions. IRS determined the projected foregone revenue by multiplying the average dollars collected per ACS staff by the projected lost case closures. IRS plans to minimize the use of SB/SE staff because the revenue collected by SB/SE is greater than for W&I.

Another cost—although not measured in dollars—is the decline in telephone service shown in table 7. Because of the increased call volume, IRS expects its assistor level of service to drop from 82 percent (the 2008 goal) to as low as 74 percent—the lowest level since 2002. IRS is already experiencing some declines in telephone service. As of March 29, the level of service had dropped to 80 percent, taxpayers were waiting a minute and a half longer than last year, and they were hanging up 43 percent more often while waiting to speak to an assistor. Between March 3 and March 29, IRS assistors answered over 572,000 stimulus-related calls.[25] IRS expects call volume to increase rapidly in upcoming weeks as taxpayers receive their stimulus notices in the mail.

Because IRS is in the early stages of implementing the stimulus legislation, IRS officials do not have much information about the actual costs. Through March, IRS estimates that it has spent almost $103 million, mostly for postage.

AGENCY COMMENTS

In commenting on a draft of our earlier report on the fiscal year 2009 budget request and 2008 tax filing season, IRS officials said that, because of the short time frame for our report, they did not have time to fully analyze our recommendation and, therefore, were unable to respond at the time. They provided technical comments at that time and again for this statement, and we made those changes where appropriate. We have agreed to meet with IRS to further discuss the ROI recommendation.

Mr. Chairman, this concludes my prepared statement. Mr. Powner and I would be happy to respond to questions that you or other members of the subcommittee may have at this time.

PREPARED STATEMENTS OF OMB WATCH AND COLLEEN KELLEY

Senator DURBIN. In addition, written statements have been received from OMB Watch and Colleen Kelley, President of the National Treasury Employees Union, on behalf of the employees of the Internal Revenue Service. Without objection, these materials will be made a part of the permanent record.

[The statements follow:]

PREPARED STATEMENT OF COLLEEN M. KELLEY, NATIONAL PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Chairman Durbin, Ranking Member Brownback, and distinguished members of the subcommittee, I would like to thank you for allowing me to provide comments on the administration's fiscal year 2009 budget request for the Internal Revenue Service (IRS). As president of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 Federal workers in 31 agencies, including the men and women at the IRS.

IRS FISCAL YEAR 2009 BUDGET REQUEST

Mr. Chairman, as you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can best fulfill its tax enforcement mission. Without an adequate budget, the IRS cannot expect to continue providing taxpayers with top quality service and will be hampered in its effort to enhance taxpayer compliance and close the tax gap.

While acknowledging that IRS employees continue to provide world class customer service and are more efficient than ever in collecting taxes and enforcing tax law, the administration continues to put forth insufficient and unrealistic budget requests that fail to allow the service to meet its customer service and enforcement challenges.

Staffing levels are dramatically below 1995 levels.

The decline in IRS personnel, particularly enforcement staff, can be attributed to unrealistic budget requests, which since 2003, have contemplated internally generated savings or "efficiency savings" to help fund proposed increased staffing for

[25] According to IRS officials, before March 3, taxpayers with stimulus-related calls were transferred to an automated message, which told taxpayers that additional information would be forthcoming. IRS estimated that the number of these calls frequently ranged from 20,000 to 60,000 per day. IRS assistors started answering stimulus-related questions on March 3, and IRS established its dedicated telephone line for stimulus-related calls on March 14.

enforcement. For fiscal year 2009, the budget request identifies "efficiency savings" of more than $94 million at the cost of almost 976 FTEs. If, as sometimes has been the case in previous years, IRS fails to realize all expected savings then the funds available for new enforcement personnel would be further reduced.

And although it's widely recognized that additional funding for enforcement provides a great return on the investment, the IRS has repeatedly told Congress that the IRS does not need any additional funding above the President' budget request.

Employee productivity is not the issue. Despite the significant decline in enforcement staff over the past 10 years, enforcement revenue has increased significantly, reaching $59.2 billion in 2007, up from $48.7 billion in 2006 and an increase of $46 billion since 2000. The $59.2 billion in collections in 2007 represents a 5.6 to 1 return on investment for all IRS activities. In addition, earlier this year the IRS Data Book for 2007 was released which demonstrated that the IRS is one of the most efficient tax collection systems in the world, spending only 40 cents to collect $100.

Yet, between 1995 and 2007, the total number of employees has shrunk from 114,064 to 86,638. Even more alarming is that during that period, revenue officers and revenue agents—two groups critical to reducing the tax gap—have shrunk by 33 and 20 percent respectively. Revenue officers went from 8,139 to 5,468 and revenue agents fell from 16,078 to 13,026. These drastic cuts have come at a time when the IRS workload has increased dramatically. According to IRS's own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, 11 years later, the Service saw 134.4 million returns filed. In addition, between 1997 and 2007, the number of individual tax returns with $100,000 in reported income, which are generally more complex returns, increased by 103 percent.

Unfortunately, instead of recognizing that the dramatic cuts to the IRS workforce are straining the ability of IRS employees to handle the increasing workload, the IRS has continued to reduce its workforce. Further exacerbating the dire staffing situation at the Service is the aging of the IRS workforce. Approximately 4,000 of its employees are retiring annually presenting the Service with the difficult challenge of replacing a large portion of its workforce each year and the institutional knowledge they take with them. These retirements of some of the Services' most experienced personnel will only further stress the current IRS workforce already straining under a rising workload.

Amazingly, IRS efforts to reduce the overall workforce have targeted some of the Service's most productive employees. These include the recent re-organization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency's 345 estate and gift tax attorneys—almost half of the agency's estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting $2,200 in taxes for each hour of work. It is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close 5 of its 10 paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But the IRS recently reported that in 2007 just 57 percent of Federal tax returns were filed electronically and has previously acknowledged that it is getting harder to convert additional taxpayers to e-filing as those that might convert most readily have already done so.

The continued slow migration of taxpayers to e-filing recently caused the IRS Oversight Board to call on Congress to extend the 80 percent deadline to 2012 in its recent report to Congress on e-filing.

In addition, while the IRS has stated that it will achieve millions of dollars in cost savings as a result of the paper submission consolidation effort, an August 2007 report by the Treasury Inspector General for Tax Administration (TIGTA) found that the agency's business decision to consolidate sites did not even include a cost-benefit analysis (TIGTA Report Number: 2007–40–165). Furthermore, the report found that the IRS had not adequately updated or monitored financial information on the personnel costs of consolidations and had included savings not attributable to site consolidation in some of its analyses. What is most disturbing is that while the IRS acknowledged some of the assumptions used to determine the consolidation plan may have changed, they refused to complete a cost-benefit analysis to determine if the existing plan is optimal or if alternatives need to be considered.

Mr. Chairman, while overall use of e-filing may be on the rise, it is clear that the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that the IRS consolidation strategy rests on an incomplete business plan which did not include any type of cost-benefit analysis, NTEU believes that the IRS should immediately postpone further site consolidations until a comprehensive cost-benefit analysis can be completed to ensure that the existing plan is optimal in terms of cost savings and benefits.

It is clear that drastic reductions in some of the agency's most productive tax law enforcement employees directly contradict the Service's stated enforcement priority to discourage and deter non-compliance. In addition, we believe these staffing cuts have greatly undermined agency efforts to close the tax gap which the IRS recently estimated at $345 billion. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some $2,000 per year to subsidize non-compliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap and handle a rising workload, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

NTEU STAFFING PROPOSAL

In order to address the staffing shortage at the IRS, NTEU believes the workforce should be gradually increased to its pre-1996 levels. Specifically, we support a 3 percent annual net increase in staffing (roughly 2,600 positions per year) over a 5-year period to gradually rebuild the depleted IRS workforce to its pre-1996 levels from its current level of 86,638. Because it takes time and careful management to hire, train, and deploy qualified professional staff, consistent but modest annual increases are necessary. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly $30 for every $1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Adding staff to handle an increasing workload at the IRS is not a new concept. In its 2001 budget request, IRS asked for funding for the Staffing Tax Administration for Balance and Equity program (STABLE), an initiative aimed at restoring IRS staffing to mid-1990s levels and strengthening the Service's tax compliance and customer service functions. The STABLE initiative envisioned hiring nearly 4,000 new employees to help increase compliance and improve customer service. The proposal sought to boost staff in Field Offices, where IRS employees provide direct, in-person service to taxpayers, and Service Center/Call Sites, where service is typically provided via telephone and correspondence. Hiring requirements for the Field Offices was to be determined based on projected workload in the office's geographic area, and existing staff capabilities. Conversely, Service Center/Call Site workload would be planned on a nationwide basis due to the nature of the work, and staffing allocations based upon physical space and local labor market conditions around the center in question.

Although such a staffing initiative would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of $9 billion in new revenue over 5 years while spending only about $2 billion during the same period. Because of the initiative's potential to dramatically increase Federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. That is why we were disappointed to see that the President's proposed budget calls for a $31 million cut in funding for Taxpayer Assistance Center (TACs) at a cost of 262 FTEs. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations will only hurt those efforts. It is clear that IRS employees are continuing to provide quality customer service to American taxpayers. 2007 year end data from the IRS shows that IRS' customer assistance centers met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. And while these numbers show that employees providing taxpayer services are helping taxpayers understand and meet their tax responsibilities, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while handling a growing workload and increasing collections, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload only expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the Nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

PRIVATE TAX COLLECTION

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the administration's private tax collection program. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you know, in September 2006, the IRS began turning over delinquent taxpayer accounts to private collection agencies (PCAs) who are permitted to keep up to 24 percent of the money they collect. NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel.

NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

According to the IRS, in fiscal year 2007, the PCAs brought in just $32 million in gross revenue, far below original projections of up to $65 million. After deducting commission payments to the PCAs, the true net revenue from PCA (non-IRS) collection activity was just $20 million. Therefore, after spending $71 million in start up and ongoing maintenance costs through the end of fiscal year 2007, the IRS private tax collection program lost more than $50 million.

According to Nina Olson, the National Taxpayer Advocate, the dismal performance of the private collectors is forcing the IRS to downwardly revise its original 10-year projections for the program. For fiscal year 2008, the IRS is now projecting gross revenues of just $23 million, despite projections as recently as last May indicating the program would bring in up to $127 million. In addition, despite assurances that the program would recover all start-up and maintenance costs by April

of this year, the IRS is now projecting the program will not break even until late fiscal year 2010.

NTEU also believes that sky high commission payments to the private contractors for work on the easiest to collect cases is unjustified and unnecessary. Under current contracts, private collection firms are eligible to retain 21 percent to 24 percent of what they collect. The legislation authorizing the program actually allows PCAs to retain up to 25 percent of amounts collected. These commission rates were never put up for competition. Before the initial bid solicitations went out, the IRS set commission rates at 21 to 24 percent of the revenue collected by contractors, denying bidders an opportunity to make offers on terms that would have resulted in the IRS getting a greater share of the collected revenue. Consequently, one of the companies that lost its bid for a contract filed a protest with GAO and noted in its bid protest that "offerors were given no credit for proposing lower fees than the "target' percentages recommended by the IRS."

The problem of excessive commission rates was recently addressed by Congress in legislation overhauling the Department of Education's student loan program, which the IRS has consistently held up as a model for the IRS private collection program. Amid charges that student aid lenders have engaged in abusive and potentially illegal collection tactics including charging excessively high collection fees, coercing consumers into payment plans they could not afford and misrepresenting themselves as Department of Education employees, the House and Senate approved H.R. 2669, the "Higher Education Access Act of 2007," which lowers from 23 percent to 16 percent the amount of recovered money that private guaranty agencies contracted by the Government can retain on defaulted loans.

Mr. Chairman, in addition to being fiscally unsound, the idea of allowing PCAs to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998 (RRA 98) which specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay PCAs out of their tax collection proceeds, which will clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid.

The fear that allowing PCAs to collect tax debt on a commission basis would lead to contractor abuse was realized when the IRS recently confirmed that the agency had received more than five dozen taxpayer complaints against the PCAs, including violations of the taxpayer privacy laws under Code section 6103. At least one of those complaints was confirmed by an IRS Complaint Panel to be a serious violation of law. In addition, penalties totaling $10,000 have been imposed by the IRS on the PCAs for taxpayer violations. In one instance, private collectors made 150 calls to the elderly parents of a taxpayer after the collection agency was notified he was no longer at that address. And one of the three private contractors was dropped by the IRS for dubious practices despite the Service's previous assurance that its oversight would prevent abuse.

Mr. Chairman, NTEU is not alone in our opposition to the private tax collection program. Opposition to the IRS tax debt collection program has also been voiced by a growing number of major public interest groups, tax experts, two former IRS Commissioners as well as the National Taxpayer Advocacy Panel, whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS previously identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and recently renewed her prior call for Congress to immediately repeal the IRS' authority to outsource tax collection work to private debt collectors.

Opposition to the program has also been growing within Congress. Since granting IRS the authority to use PCAs in the American Jobs Creation Act of 2004, the House of Representatives, with bi-partisan support, has twice passed language prohibiting the IRS from moving forward with its private collection initiative. In addition, last session, the House overwhelmingly approved two separate tax bills (H.R. 3056, the "Tax Collection Responsibility Act of 2007" & H.R. 3996, the "'Temporary Tax Relief Act of 2007") that contain language that would repeal IRS' authority to use private debt collectors to pursue tax debts.

In the Senate, stand alone legislation (S. 335) introduced by Senator Byron Dorgan (D-ND) that would force the IRS to immediately and permanently suspend its plan to outsource part of its tax debt collection responsibilities to PCAs and prohibit the use of any IRS funds for that purpose has 24 co-sponsors.

Mr. Chairman, instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the Federal Government and undermines efforts to close the tax gap, NTEU believes the IRS should increase compliance staffing levels at the agency to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

The IRS already has a significant collection infrastructure with thousands of trained employees, including 14 Automated Collection System (ACS) sites which allow the IRS to contact taxpayers by telephone and collect delinquent taxes. The ACS function is a critical Collection operation, collecting nearly $1.49 million per employee per year. The IRS itself has analogized the use of private collectors to the ACS, where IRS collection representatives interact with taxpayers on the telephone. But unlike the private collectors, ACS personnel are able to analyze financial statement information, research assets, enter into installment agreements, make currently not collectible determinations, and can take lien and/or levy enforcement actions. ACS employees also receive training that is far more comprehensive and rigorous than that of the private collectors. In addition, these employees undergo mandatory annual training on topics such as confidentiality and privacy of taxpayer information, ethics awareness, taxpayer rights and computer security.

Unfortunately, inadequate staffing at ACS sites has prevented the IRS from using its current systems to proactively contact taxpayers by telephone to resolve delinquent accounts. The need for the IRS to expand ACS' use of outbound calls has been recognized by IRS management and at least two recent internal IRS study groups have recommended making more outbound calls as a way to make the ACS operation more effective and efficient.

Mr. Chairman, according to the IRS they will spend $7.65 million to run the private collection program in fiscal year 2008. NTEU believes that instead of continuing to expend valuable IRS resources on this failed program, this $7.65 million should instead be used to fund roughly 102 additional ACS employees that could return more than $151 million to the Treasury annually. By comparison, the IRS is now projecting the PCAs to bring in just $23 million in gross revenue in fiscal year 2008, far less than its original estimate of up to $127 million.

NTEU believes that increasing the number of ACS personnel would allow the IRS to maximize its ability to proactively resolve delinquent accounts by contacting taxpayers directly. This would also help ensure that the high level of customer service to those taxpayers who call the ACS seeking account resolution is preserved. The IRS has acknowledged that ACS employees are already performing admirably noting that in 2006, ACS customer service and quality ranged between 89.5 to 99.5 percent (pg. 54—IRS response to Olson 2006 Report to Congress). These exceptional ratings are all the more impressive when you consider ACS employees generally work on much more complex and often contentious cases than those being worked by the private collectors and that the total number of cases worked by ACS employees dwarfs those worked by the private collectors.

Mr. Chairman, NTEU understands and commends efforts to ensure that all taxpayers pay their fair share of taxes. Without a doubt, rank and file IRS employees are committed to achieving this goal in the most cost-effective manner while providing a high level of customer service to American taxpayers. But the facts make clear that the use of private tax collection companies is not in the best interest of American taxpayers, could potentially undermine future efforts to close the tax gap, and should be terminated immediately.

A number of other issues important to NTEU members are often addressed in the FSGG Appropriations bill and I would like to address some of them here.

PAY RAISE

The Federal Employees Pay Comparability Act (FEPCA), enacted in 1990 to close the gap between Federal and private sector pay, has never been fully implemented. As a result, there is now a 23 percent disparity between Federal employees and their private sector counterparts. Under the President's plan, Federal employees will fall even further behind the private sector.

The administration's budget proposed a 2.9 percent pay raise for Federal workers next year. This not only fails to recognize the important role of our Nation's workforce, it is below the 3.4 percent pay raise the President recommended for the military. The administration's recommendation ignores the essential role of Federal employees in protecting our Nation at the borders, in the domestic and international movement of money, in public health, in nuclear security, and in the collection of revenue among others. Further, it ignores the longstanding principle of pay parity, the recognition that Federal civil servants and their brothers and sisters in the military, work side by side and should receive an equal level of pay increase. Importantly, pay parity was just reaffirmed on March 13, 2008, in House of Representatives when it passed H. Con Res. 312, the fiscal year 2009 budget resolution. I urge the subcommittee to report its bill in keeping with this pay parity principle.

For most of the last 20 years, Government employees in civil service and military personnel have received the same level of pay increase. Last year, both the military

and Federal civil servants received a 3.5 percent pay raise in the final fiscal year 2008 bills. That amounted to the annual raise in the Employment Cost Index (ECI) plus one-half percent, the standard pay figure received in every year of the current administration with the exception of 2007. For 2009, the current raise in the ECI as calculated by the Department of Labor is 3.4 percent, and an extra one-half percent equals 3.9 percent. NTEU urges the subcommittee to follow the precedent of ECI plus one-half percent and report legislation for fiscal year 2009 providing a 3.9 percent raise to Federal employees. We will be working with the appropriate committees to enact a military raise of the same level.

SEC Pay

NTEU represents the employees of the Securities and Exchange Commission (SEC). We believe that the SEC must be provided with adequate resources to ensure that its performance based pay system can be a viable tool for employee retention and recruitment. While there have been numerous problems with this pay system, adequate funding is essential. From fiscal year 2002 to fiscal year 2005, the SEC budget included a 3 percent increase over current compensation levels to fund the performance pay system. However, for the past 2 years, the SEC's budget has included only a 2 percent increase. This year, the President has only requested a 1.5 percent increase. The continuing performance pay funding crisis has hamstrung SEC managers' ability to provide meaningful and appropriate performance based salary increases to their employees. As budget shortfalls have shifted the system from being fundamentally performance based, some senior managers at the SEC have sent notices to their employees stating that they are being given lower ratings not for performance reasons but because of budgetary limitations. This state of affairs is having severe and negative impacts on employee morale and retention at SEC, contrary to the stated purpose of the performance pay system. NTEU would ask for an additional $5 million in funding for the SEC for this purpose.

OPM PRESCRIPTION DRUG SUBSIDY

Mr. Chairman and members of the subcommittee, it is NTEU's position that OPM should apply for the drug subsidy to which it is entitled under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108–173). Under this law, which created the Medicare Part D prescription drug program, the Government, as an employer, is eligible to receive a subsidy payment made available to all employers that provide prescription drug benefits as generous as the Medicare program. The "Medicare employer payment" was designed to encourage employers to retain such benefits.

According to GAO, if OPM had applied for the subsidy, it would have lowered the average 2006 FEHBP premium by 2.6 percent. Some of the individual health plans that serve a high number of retirees could have realized a slowdown in premium growth by as much as 3.5 to 4 percent. These savings could have been passed on to keep the enrollee portion of the premium down. Unfortunately, estimates are that OPM has have left more than $1 billion on the table by forgoing the subsidy. NTEU would support legislative language require OPM to apply for the subsidy, which would help keep FEHBP costs down for millions of Federal employees and their families who are enrolled.

CONTRACTING OUT

Another issue pertinent to the subcommittee's jurisdiction is the contracting out of Government positions and responsibilities. I want to commend and thank the subcommittee for incorporating important privatization language in its portion of the fiscal year 2008 Omnibus Appropriations bill to help level the playing field for Federal employees.

Unfortunately, the administration's fiscal year 2009 budget request has called for the repeal of these important provisions. We strongly urge Congress to oppose any efforts to repeal these important provisions that allow Federal employees the ability to fairly compete with the private sector.

In addition, NTEU strongly supports making Government-wide a number of additional contracting out reforms included in the fiscal year 2008 Defense Authorization Bill which currently only apply to the Department of Defense. These include provisions that would encourage "insourcing" by providing employees Government-wide the opportunity to compete for new work or work currently performed by contractors, allow Government employees to acquire new work by allowing agencies to bring work in-house without going through the A–76 process, eliminate the automatic recompetition requirement which previously only applied to Federal employees and not contractor employees, and establishment of a contractor inventory in

every Government agency to track the cost and performance of every service contract to help identify contract work that could be converted to performance by Federal employees.

By making these important contracting out reforms applicable to the entire Federal workforce, Congress can help bring fairness and accountability to the entire competitive sourcing process. NTEU firmly believes that Federal employees are the best value for taxpayers' dollars and they deserve a fair and level playing field on which to demonstrate their effectiveness and efficiency to the White House, Congress, and the American public.

CONCLUSION

Mr. Chairman, while Federal workers, and in particular IRS employees, continue to get mixed signals regarding their value to this administration, they remain committed to serving the American public to the best of their abilities. With the expected surge in Federal retirements in the coming years, it is imperative that the Federal Government do all it can to retain the hundreds of thousands of talented public servants who have the knowledge and expertise to continue contributing to the Federal workforce while at the same time preparing to compete for the best and brightest of the young new workers.

Therefore, NTEU believes it is imperative that the administration reverse many of its policies that have devalued the role of Federal employees and the work that they do including the failure to pay competitive salaries and the constant focus on downsizing and outsourcing. These misguided policies have reduced morale of Federal employees Government-wide and have put the Federal Government at a disadvantage when it comes to attracting, developing and retaining qualified employees.

PREPARED STATEMENT OF OMB WATCH

OMB Watch would like to submit the report, "Bridging the Tax Gap: The Case for Increasing the IRS Budget," into the record for the Committee on Appropriations Subcommittee on Financial Services and General Government hearing on the IRS fiscal year 2009 budget on April 16, 2008.

OMB Watch supports efforts by the IRS to close the so-called "tax gap," and believes increased funding of the IRS budget is a necessary condition to achieving this goal. The $4.6 billion appropriated to the IRS's enforcement budget in fiscal year 2008 is less than the 1995 IRS enforcement budget (in inflation-adjusted terms). As the enforcement budget was cut, the IRS saw the number of tax returns filed increase 11 percent from 205 million in 1995 to 228 million in 2006 (the last year for which such data are available).

In addition to the amount of resources available to the IRS, also of concern are the means by which the IRS enforces tax laws. The use of private tax collectors not only exposes taxpayer data to private firms, but when compared to Federal tax collectors, private collectors are extremely inefficient. Use of Federal employees for tax collection results in a 13:1 return-on-investment (ROI) ratio ($13 collected for each dollar spent), while private tax collectors achieve an ROI of 4.5:1. That the IRS would continue this program represents an egregious mismanagement of tax collection resources.

OMB Watch also believes better targeting of audits and the types of audits performed would enhance the IRS's ability to close the tax gap. Although the overall audit rate has seen a slight increase in recent years (a positive development, to be sure), that increase has been largely constituted of increases in correspondence audits. Compared to face-to-face audits, correspondence audits result in lower revenue yields. Whereas correspondence audits of individuals earning over $100,000 per year result in about a $32,000 increase in identified tax liability, face-to-face audits yield, on average, about $55,000.

Additionally, the IRS has been spending too much time auditing low-income Americans. Forty percent of all audits performed in 2006 were of taxpayers claiming the EITC, resulting in a 2.25 percent audit rate for EITC claimants—more than double the 1 percent rate for all taxpayers. With an average yield of $2,895, EITC-return audits have the lowest rate of return of any audit conducted by the IRS. That so many IRS resources are devoted to these low-yield audits underscore the depth of inefficient enforcement practices.

Instead of employing this punitive approach to closing the tax gap through EITC compliance, the IRS should increase resources devoted Taxpayer Assistance Centers (TAC) to increase EITC return accuracy. TAC-prepared EITC returns reduce overpayments by $640–$1,300. However, the number of TAC-prepared returns have

been declining as TACs experience staffing shortages. By increasing resources devoted to TACs, the IRS would not only reduce the tax gap, but would expand much-needed services to low-income taxpayers.

These important tax enforcement issues, and others, are explored in greater detail the report we are submitting. We hope this will help raise awareness of the importance of addressing enforcement issues at the IRS and that the committee will use the findings of this report in formulating IRS legislation.

JANUARY 2008.

BRIDGING THE TAX GAP—THE CASE FOR INCREASING THE IRS BUDGET

ACKNOWLEDGEMENTS

Matt Lewis, a Federal Fiscal Policy Analyst, conducted the primary research and writing of this report, with assistance from Adam Hughes, Director of Federal Fiscal Policy. Other OMB Watch staff provided advice and research support. Brian Gumm, Communications Coordinator, provided editorial support and designed the report.

OMB Watch is a nonprofit research and advocacy organization whose core mission is increasing Government accountability and improving citizen participation. Responsible, fair, and equitable budget and tax policy has been an important part of our work for more than 20 years, and we have practical experience in promoting and informing the public on budget and tax legislation and regulations.

This report is available electronically at: http://www.ombwatch.org/budget/irstaxgap2008.pdf.

INTRODUCTION

A significant and pernicious problem facing the Nation is the tax gap, the difference between what is owed in taxes and what is paid. Estimated to be over $300 billion annually, the tax gap represents an enormous revenue loss for the Government. This lack of revenue often causes unnecessary increases in annual deficits and the national debt, increasing national interest payments and adding pressure to cut vital Government services. Unfortunately, much of the gap must be made up eventually by honest taxpayers through higher taxes and by beneficiaries of Federal investments through service cuts.

The Internal Revenue Service (IRS) is responsible for enforcing tax laws and collecting taxes, and therefore, it has the greatest capacity and responsibility to reduce the tax gap. The extent to which the IRS can influence the tax gap is mostly a product of the resources and powers lawmakers in Congress provide the agency and how well IRS administers those resources and powers.[1]

Congress has given considerable lip service to doing something about the tax gap for years but has done little to actually give the IRS the tools to make significant progress in closing it. Despite this fact, Congress has demanded the IRS close the tax gap without making more resources available for the agency to do so. Thus, the IRS has been forced to make difficult choices as to how to use the limited resources it has been allocated. As a result, at the very least, the tax gap remains a large problem, and most experts believe it has probably increased in size as the IRS has largely scaled back tax law enforcement over the last 10 years.

The IRS can reduce the size of the tax gap—progress that would yield billions in additional revenue each year. In order to accomplish this, Congress and the IRS will need to invest more in three areas of the IRS budget: audits, collections, and tax preparation services for low-income taxpayers eligible for the Earned Income Tax Credit. With sufficient resources, the IRS should be able to implement effective and efficient tax enforcement policies and programs that will have a real impact on reducing the tax gap.

THE $300 BILLION PROBLEM: THE TAX GAP

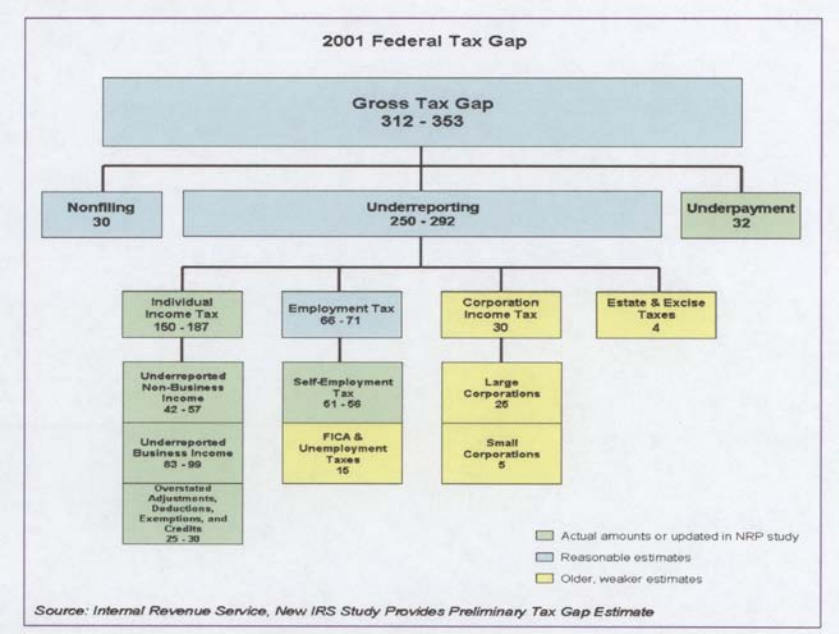
IRS defines the tax gap in two ways. The gross tax gap is the total amount of taxes that were not paid when tax returns were first filed, while the net tax gap consists of taxes that are not paid after the IRS takes steps to enforce tax laws. The most recent data on the gross tax gap comes from the IRS National Research Project, which evaluated tax returns from fiscal year 2000. It put the gross tax gap at between $312 billion and $353 billion annually, or about 16 percent of all taxes owed. Although the percentage of the economy the tax gap represents has not

[1] Significant changes to tax laws have reduced the IRS's influence over tax enforcement, and many proposals have been made to increase tax compliance with authorizing legislation. For one in-depth overview, see Max Sawicky's *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005).

changed significantly, the absolute size of the gross tax gap has in all likelihood grown in step with the economy.[2] Most of the tax gap results from taxpayers underreporting their income.

It is unclear, however, how much the tax gap has increased as a percentage of the total amount of taxes owed. In the last two decades, IRS has only measured the tax gap three times. Each time, it found the tax gap represented between 16 and 20 percent of total revenues owed.[3] On the other hand, anecdotal evidence, particularly the work of Pulitzer Prize-winning journalist David Cay Johnston, suggests the tax gap has grown as wealthier taxpayers have responded to and requested reductions in the IRS enforcement presence.

In any case, the IRS can influence both the net and the gross tax gap by encouraging and requiring tax compliance. The IRS recovered $48.7 billion of the tax gap in fiscal year 2006, which, coupled with late payments, brought the net tax gap to between $257 billion and $298 billion.[4] Enforcement efforts also have a strong impact on the gross tax gap, because voluntary compliance tends to increase when enforcement programs are more active. More enforcement increases the fear of being audited and perhaps heightens the public sense of civic responsibility, both of which are thought to promote voluntary compliance. But the exact extent of the impact is subject to debate. Some studies have found the increase in voluntary compliance is many times greater than the money the IRS directly recovers through enforcement programs.[5]



IMPACT OF THE TAX GAP

The tax gap affects the public in two ways. Mainly, it reduces what compliant taxpayers already have. Because this revenue is intended to be collected and used by the Government, not collecting it makes implementing Government services and in-

[2] Internal Revenue Service, "New IRS Study Provides Preliminary Tax Gap Estimate," http://www.irs.gov/newsroom/article/0,,id=137247,00.html (accessed October 10, 2007).

[3] Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, http://www.taxpolicycenter.org/UploadedPDF/411496__reducing__tax__gap.pdf (accessed October 10, 2007).

[4] Internal Revenue Service, "IRS Enforcement Activities Continue To Recover," http://www.irs.gov/pub/newsroom/11-06__stat__charts.pdf (accessed October 10, 2007).

[5] Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, http://www.taxpolicycenter.org/UploadedPDF/411496__reducing__tax__gap.pdf (accessed October 10, 2007).

vestments more difficult. The existence of the tax gap is kind of like a recurring and permanent tax cut, in the sense it generally must be paid for by either shifting the tax burden to others (in this case, compliant taxpayers), curtailing Government services, or increasing debt. The IRS National Taxpayer Advocate (NTA), for example, has testified before Congress that unpaid taxes shift the tax burden onto compliant taxpayers. If all compliant taxpayers were to assume an equal portion of the tax gap, it would add $2,200 to their annual tax bills.[6] Looked at another way, if the IRS eliminated the tax gap, Americans could receive the same level of services and programs while paying significantly less in taxes. The actual impact of the tax gap on the taxes paid by each individual most likely depends on personal circumstances and future policy decisions.

But unlike a tax cut, the tax gap creates a patently perverse set of winners and losers—taxpayers who do not follow the law benefit and taxpayers who do lose out. Larger burdens also tend to fall on lower-and middle-income taxpayers, whose compliance rates are higher than other income levels. Higher-income taxpayers, small business owners, and corporations are the main beneficiaries, as their compliance rates are lower. Because of this, on the whole, the tax gap makes the tax code less progressive than the statutory structure indicates, though by exactly how much has not been quantified.[7]

Secondly, and perhaps more importantly, the tax gap reduces what the public could have. The tax gap deprives the Government of more revenue to finance the expansion of Government services and investments, a reduction in the annual deficit, or payments to reduce the national debt. If the tax gap were reduced or eliminated, the additional revenue brought into the Government would, in most circumstances, make the tax code much more progressive. There are surely many different proposals about how to invest the revenue owed, but regardless of how the $300 billion would be used, the Federal Government is never afforded the opportunity to decide.

On a less practical, but equally important level, the tax gap also represents the eroding integrity of the tax system and could reduce public support for the Federal Government. Such a large amount of unpaid taxes makes the tax system appear ineffective and unfair, since the tax gap regressively favors wealthier people and businesses who have the means to avoid and evade tax law. These perceptions of unfairness in the tax system may have large-scale effects on public policy, undermining public confidence in Government as a fiscal manager.[8] Compliant taxpayers may also object to tax increases on the grounds they would be paid arbitrarily and regressively, and, as a corollary, new Government services or investments financed by tax increases may receive less support. Taxpayers may also view ineffective tax enforcement as indicative of Government incompetence generally and, therefore, oppose expansion of the Government's role. Too many citizens may see no option but to favor tax cuts as a way to restore the integrity of revenue collection and protect themselves from bearing unjust burdens as compliant taxpayers.

A PRIMARY CAUSE: LACK OF RESOURCES AT THE IRS

While it is widely established that increased resources at the IRS could help to reduce the tax gap, IRS funding levels have not kept up with growing demands on its budget. The total IRS budget has remained static after adjusting for inflation since the mid-1990s. The funding decline has been most pronounced in the enforcement account of the IRS budget, which includes funding for tax return examinations, tax collections, and document matching services that compare financial records with tax returns. In fiscal year 1995, IRS had $4.43 billion in its enforcement account. By fiscal year 2006, this budget had only risen to $4.65 billion—less than a 5 percent increase. During the same period:

—Inflation had eroded the value of this funding by 36 percent;[9]

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[6] National Taxpayer Advocate, "National Taxpayer Advocate's 2006 Annual Report To Congress," Internal Revenue Service, http://www.irs.gov/advocate/article/0,,id=165806,00.html (accessed October 10, 2007).

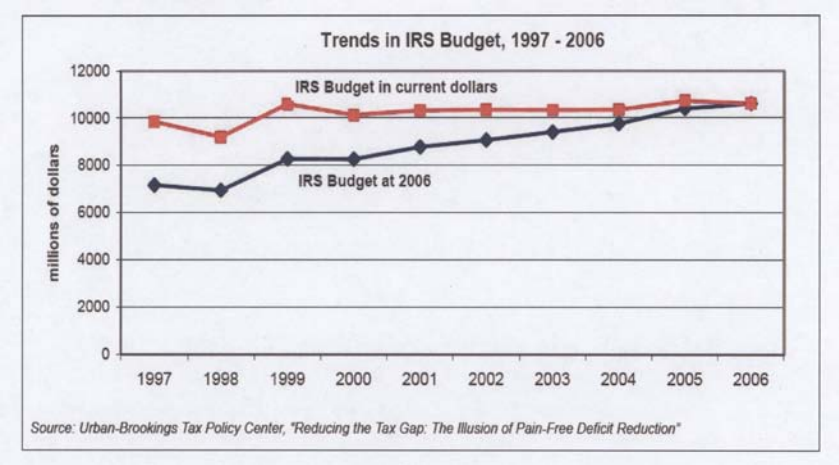
[7] Jason Furman, Lawrence H. Summers, and Jason Bordoff, "Achieving Progressive Tax Reform in an Increasingly Global Economy," Brookings Institution, http://www3.brookings.edu/views/papers/furman/200706bordoff__summers.pdf (accessed October 10, 2007).

[8] Alison Kladec and Will Friedman, "Understanding Public Attitudes about the Federal Budget: A Report on Focus Groups," Public Agenda, http://www.publicagenda.org/research/pdfs/understanding__public__attitudes__about__the__federal__budget.pdf (accessed October 10, 2007).

[9] Bureau of Labor Statistics. "Inflation Calculator," U.S. Department of Labor, http://www.bls.gov/cpi/ (accessed October 10, 2007).

—The size of the economy grew 42 percent; [10]
—The number of tax returns the IRS processed increased 11 percent, from 205 million to 228 million; [11] and
—Hundreds of changes to the IRS's authority and tax laws gave the agency more work.[12]

Experts inside and outside Government have recognized the resource problem at IRS. IRS National Taxpayer Advocate Nina Olson, who operates independent of the IRS, believes funding shortages have become so problematic, she has called for the creation of special rules for IRS budget bills. Charles Rossotti, former commissioner of the IRS, told the IRS Oversight Board in 2002 that much of the tax gap is a result of the failure of Congress to provide enough resources for tax law administration:



The source of this problem are two conflicting, long-term trends: one, ever increasing demands on the tax administration system due to rapid growth in the size and complexity of the economy; and two, a steady decline in IRS resources due to budget constraints. The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers who are not filing, not reporting or not paying what they owe, and the IRS' capacity to require them to comply.

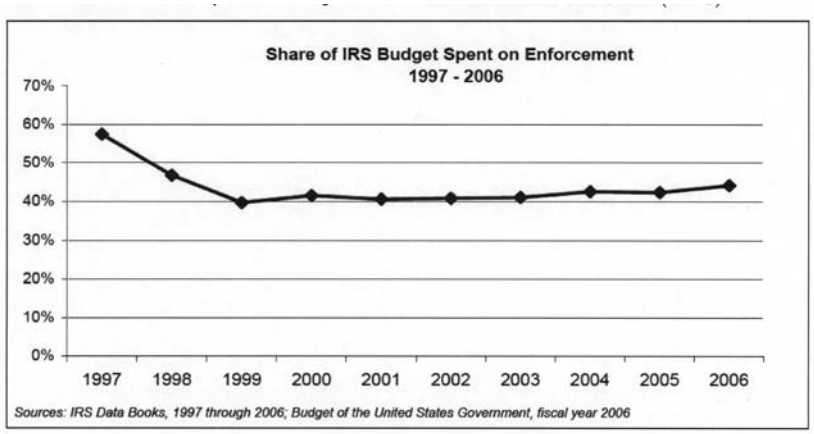
The resources crunch can be seen more apparently in staffing levels: the number of IRS employees is down sharply from 10 years ago. Between 1995 and 2006, the total number of IRS employees shrunk 18 percent—falling from 114,000 to less than 92,000. The number of revenue agents and officers—IRS employees who perform audits—has decreased even faster, by 40 and 30 percent, respectively.[13] Those categories of employees have decreased from 8,139 to 5,665 for revenue agents and 16,078 and 12,859 for revenue officers.[14] Fewer staff at the IRS has a direct impact on the auditing function at the agency.

There have been many experts who have called for increased funding for the IRS, including the Treasury Inspector General for Tax Administration,[15] the Government Accountability Office,[16] the IRS Oversight Board, Max Sawicky, then of the Eco-

[10] Bureau of Economic Analysis, "National Economic Accounts" U.S. Department of Commerce, http://www.bea.gov/national/index.htm#gdp (accessed October 10, 2007).
[11] Internal Revenue Service, "SOI Tax Stats—IRS Data Books," http://www.irs.gov/taxstats/article/0,,id=102174,00.html (accessed October 10, 2007).
[12] Charles O. Rossotti, "Report to the IRS Oversight Board: Assessment of the IRS and Tax System," http://nteuirswatch.org/documents/numbers/Rossotti%2002%20report%20to%20oversight%20board.pdf (accessed October 10, 2007).
[13] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."
[14] Ibid.
[15] Treasury Inspector General for Tax Administration. "Trends In Compliance Activities Through Fiscal Year 2006," U.S. Department of the Treasury, http://www.treas.gov/tigta/auditreports/2007reports/200730056fr.html (accessed October 10, 2007).
[16] Michael Brostek, "Tax Compliance: Multiple Approaches Are Needed To Reduce The Tax Gap," Government Accountability Office, http://www.gao.gov/new.items/d07488t.pdf (accessed October 10, 2007).

nomic Policy Institute,[17] Robert McIntyre of Citizens for Tax Justice,[18] Eric Toder of the Urban-Brookings Tax Policy Center,[19] and former IRS Commissioner Donald C. Alexander.[20]

IRS needs additional funding to fulfill its mission as the guarantor of tax compliance. Where funding is needed most is in the IRS enforcement budget, particularly for audits of high-income taxpayers and corporations, the collection function, and services for low-income taxpayers who receive the Earned Income Tax Credit (EITC).



INCREASES RESOURCES FOR AUDITS

One of the most disturbing trends in enforcement policy over the last 10 years has been a sharp decline in audits, which are an essential tool in the fight against unpaid taxes. Most of the gross tax gap—between $250 and $260 billion—results from individuals and businesses underreporting their income. The IRS determines who inaccurately reported their income and how much they owe in taxes through a variety of means. Examinations, or audits, are one way the IRS makes this determination. In fiscal year 2006, IRS audits showed that an additional $43.95 billion was owed on all tax returns that were audited.[21] The IRS performed 1.4 million audits, resulting in an audit coverage rate of 0.8 audits per 100 tax returns, or less than 1 percent.[22]

In the last decade, there has been a general decline in most types of audits. In fiscal year 1996, the audit rate for all individual income tax returns was 1.67 percent.[23] In fiscal year 2006, the rate had dropped to 1 percent of all individuals, after reaching a low of 0.5 percent in 2000.[24] The recent upswing in audits is encouraging, but the rate is still far below earlier levels and even farther below historic and adequate levels, according to tax administration experts.[25]

Making things worse, the general decrease in audits has been unequally distributed by taxpayer income with audits of higher-income earners falling faster than the overall decrease. The decline in audits has been the steepest among taxpayers

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[17] Max Sawicky, "Do-it-yourself tax cuts: The crisis in U.S. tax enforcement" in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005).

[18] Robert McIntyre, "Statement of Robert S. McIntyre Before the Senate Budget Committee, January 23, 2007," Senate Budget Committee, http://budget.senate.gov/democratic/testimony/2007/McIntyre_TaxGap012307.pdf (accessed October 10, 2007).

[19] Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf (accessed October 10, 2007).

[20] Max Sawicky, "Interview: Former IRS Commissioner Donald C. Alexander" in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005) 52.

[21] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

[22] Ibid.

[23] Government Accountability Office, "Tax Administration: Audit Trends and Results for Individual Taxpayers," http://www.gao.gov/archive/1996/gg96091.pdf (accessed October 16, 2007).

[24] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

[25] Sawicky, "Interview: Former IRS Commissioner Sheldon S. Cohen," 25.

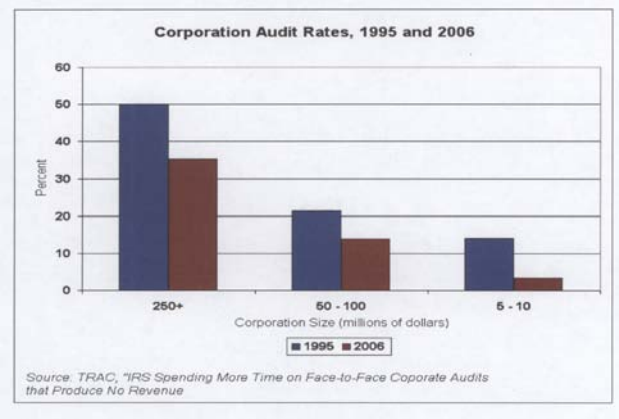
reporting an income over $100,000. Audits of these filers have dropped from 2.85 percent in fiscal year 1996 to 1.3 percent in fiscal year 2006. Decreases in these audits before 1996 were even more drastic: in fiscal year 1992, higher-income filers were audited 5.28 percent of the time.

Furthermore, business income has been insufficiently audited. Business income, which is reported on individual income tax returns, has been audited at a relatively steady rate since fiscal year 1995. Nevertheless, more audits are needed, as the IRS National Research Project identified the underreporting of income by small businesses as the category that contributed the most to the tax gap, accounting for more than $109 billion in unpaid taxes annually. $68 billion of these unpaid taxes are owed by self-proprietorships, known more commonly as the self-employed, and another $22 billion came from partnerships, S corporations, estates, and trusts. In order to close the tax gap, the IRS will need the necessary resources to expand its investigation and enforcement of tax laws related to these returns, not hold them steady.

Decline in Quality and Quantity of Corporate Audits

Individual taxpayers are not alone in experiencing a decrease in the likelihood of being audited. Audits related to the corporate income tax for all sizes of corporations have declined significantly. The overall corporate audit rate has been cut in half, dropping from 2.4 percent in 1996 to 1.2 percent in 2006.[26] What's more, new data from the last 5 years obtained by the Transactional Records Access Clearinghouse (TRAC) show that the quality of those audits has also suffered.

Disturbingly, the decline has been most pronounced among the largest corporations. Audits of corporations with assets between $5 and $10 million dropped from 14 percent in fiscal year 1995 to 3.4 percent in fiscal year 2006—a 70 percent drop.[27] Slightly larger corporations—with assets of $50 million to $100 million—were audited at a rate of 13.8 percent in fiscal year 2006, down from 21.3 percent in fiscal year 1996—a 35 percent decline. Audits of the largest corporations, those with assets of $250 million or more, have declined by almost a third, from 50 percent in fiscal year 1995 to 35.2 percent in fiscal year 2006.[28] While companies with over $250 million in assets are small in number—they filed only 0.2 percent of corporate tax returns in 2002—they accounted for a staggering 90 percent of all corporate assets and 87 percent of all corporate income during that year.[29] The decrease in audits among these corporate tax filers must be reversed.



Audits of the largest corporations inexplicably vary by sector, which seems to be an inefficient method of tax enforcement. In fiscal year 2006, only 15 percent of fi-

[26] Transactional Records Access Clearinghouse, "IRS Spending More Time on Face-to-Face Corporate Audits that Produce No Revenue," Syracuse University, http://trac.syr.edu/tracirs/newfindings/current/ (accessed October 16, 2007).

[27] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

[28] Transactional Records Access Clearinghouse, "IRS Spending More Time on Face-to-Face Corporate Audits that Produce No Revenue."

[29] Transactional Records Access Clearinghouse, "Relatively Few Corporations Have Most Income and Assets," Syracuse University, http://trac.syr.edu/tracirs/trends/v10/corpassets.html (accessed October 17, 2007).

nancial services corporations were audited, compared to 100 percent of all large manufacturing and transportation 1corporations.[30] Yet companies in the financial sector make up a large part of the economy. The largest corporations in the financial sector account for 25 percent of total receipts of large corporations and over 62 percent of total net income—more than 2.5 times the next highest sector.[31]

What's more unfortunate, however, is that the audits that have been done for corporate filers have been increasingly unproductive, particularly among face-to-face corporate audits—the most thorough and intense audits the IRS conducts. The number of nonproductive auditing hours, which is defined by the IRS as face-to-face examination hours that produce a "no change" result in the amount of tax owed, has increased for every corporate asset class over the last 5 years.[32] The average increase in unproductive hours across all corporate asset classes between fiscal year 2001 and fiscal year 2006 was 40 percent. If the IRS audited a high percentage of corporations, a rise in unproductive hours could be interpreted as a good thing, with companies increasingly paying the taxes they owe. However, because the IRS audits too few corporations and because the tax gap points to large amounts of taxes not being collected, a rise in unproductive hours shows the IRS is being inefficient in selecting which corporations it chooses to audit—a waste of valuable enforcement resources and a missed opportunity to collect more tax revenues.

The rise in unproductive auditing hours increased at faster rates as the size of the corporation increased, especially for large corporations (those with assets over $10 million). While all four asset classes over $10 million saw increases in unproductive hours well above the average of 40 percent, as the asset class grows larger, the increases are even more pronounced. At the low end, audits of corporations between $10 million and $50 million saw a 61 percent increase in unproductive hours, while audits of corporations above $250 million in assets saw the largest increases, at 109 percent—more than double the rate from 5 years earlier.[33]

Another alarming trend is the decrease in the number of hours spent per corporate audit. In the last 5 years, every corporate asset class except one ($10–$50 million) has seen double-digit decreases in the average length of audits, with the average corporate audit lasting 21 fewer hours.[34] This represents almost a 10 percent drop in the length of corporate audits.

IRS data on corporate audits, combined with the new data obtained by TRAC on audit length, depict disturbing trends in both the quality and quantity of corporate audits—particularly those of the largest corporations. Not only is the IRS performing fewer corporate audits overall than it did 10 years ago, the ones they do perform are done too quickly and are poorly targeted. Due to the size and complexity of the business transactions of large corporations, those returns are likely to produce more reporting errors, and therefore, the IRS should be auditing more of those companies (not less) and spending more time (not less) on each audit.

There have been a few reports that some of the changes within the corporate auditing section (the Large and Mid-Sized Business Division) have been forced on IRS auditors by senior level managers at the IRS. These changes put a strong focus on completing more audits by pre-set deadlines in order to drive up total audit numbers regardless of the quality of the audit or of auditors' opinions about possible serious tax violations they had not had time to investigate during audits. David Cay Johnston reported in The New York Times on March 20, 2007, that almost two dozen revenue agents had been pressured by their managers to close open audits too soon—actions the auditors said could cost the Government billions of dollars in unpaid taxes.[35]

This phenomenon was recognized by Colleen Kelley, President of the National Treasury Employees Union, in testimony before the House Appropriations Committee on Financial Services and General Government. Kelley testified the pressure

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[30] Transactional Records Access Clearinghouse, "Corporate Audit Rates—Wide Disparities Found for Different Industries," Syracuse University, http://trac.syr.edu/tracirs/latest/127/. (accessed October 16, 2007).

[31] Transactional Records Access Clearinghouse, "Net Income of Largest Corporations," Syracuse University, http://trac.syr.edu/tracirs/trends/v10/netincsecG.html (accessed October 16, 2007).

[32] Transactional Records Access Clearinghouse, "Net Income of Largest Corporations."

[33] Transactional Records Access Clearinghouse, "IRS Corporate Audit Hours Spent on Nonproductive Examinations Increasing," Syracuse University, http://trac.syr.edu/tracirs/trends/v12/audittimechange.html (accessed October 16, 2007).

[34] Transactional Records Access Clearinghouse, "Change in Average Audit Length Fiscal Year 2001 vs Fiscal Year 2006," Syracuse University, http://trac.syr.edu/tracirs/trends/v12/auditlengthchange.html (accessed October 16, 2007).

[35] David Cay Johnston, "IRS Agents Feel Pressed To End Cases." New York Times, March 20, 2007. http://www.nytimes.com/2007/03/20/business/20tax.html.

put on IRS auditors was not a recent occurrence but had been happening since 2002. Kelley believes it was the result of a new IRS policy called Limited Focused Examination (LIFE) and said the union had heard directly from its members that the policy was undermining both efforts to make sure companies were paying all the taxes they owed and employee morale at the IRS.[36]

The combination of a decrease in overall corporate audit rates, and reports that those audits being done are closed too soon, will encourage tax evasion behavior among corporations, which may have more cause to believe they will not be audited, and that audits themselves are not to be feared.

Wrong Strategy: Relying on Correspondence Audits

As far as reducing the tax gap is concerned, the type of audit being administered is equally, if not more important than who is being audited. There are two types of audits: a traditional face-to-face audit, which can happen inside an IRS office or at a taxpayer's home or business, and a correspondence audit. Traditional face-to-face audits involve comprehensive reviews of assets and records, requiring more time and effort for both the taxpayer and the IRS. Correspondence audits consist of the IRS sending a letter to a non-compliant taxpayer in which he or she is asked a few questions about his or her tax return. Striking the right balance between these two types of audits is essential to effective tax enforcement.

Face-to-face audits typically generate far more revenue than correspondence audits, and ones on high-income earners in particular produce the highest yields. In fiscal year 2006, face-to-face audits of high-income earners generated an average of $54,934.[37] Face-to-face audits on individuals earning between $50,000 and $100,000, in contrast, only averaged a $3,877 yield, yet these taxpayers were audited almost as much (0.23 percent) as their higher-income counterparts (0.44 percent).[38] Even face-to-face audits on returns with business income over $100,000 yielded less than half as much ($25,787) as audits of high-income filers.[39] The high yields on face-to-face audits of high-income filers show both that they are a good investment and also that there are significantly more taxes due among those filers.

Despite the high yields of these audits, the IRS is performing them too rarely. IRS administered face-to-face audits for 0.44 percent of all high-income filers in fiscal year 2006, compared to 2.9 percent in fiscal year 1992 and 1.7 percent in fiscal year 1996.[40] Yet the IRS claims, and rightly so, that overall audit rates have been gradually increasing in the last few years. These additional audits have increased the yield on tax enforcement, from a 10-year low of $32.9 billion in fiscal year 1999 to $48.7 billion in fiscal year 2006.

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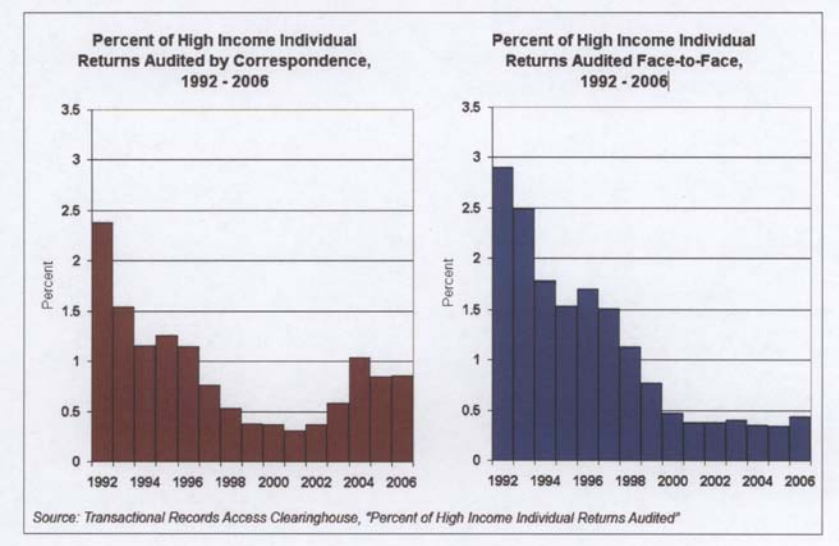
[36] Colleen Kelley, "Statement of Colleen Kelley, National President, National Treasury Employees Union on 'Internal Revenue Service Budget fiscal year 2008,'" National Treasury Employees Union, http://nteuirswatch.org/documents/numbers/CMK%20Testimony%20to%20House%20FServices%20sub%203-29-07.pdf (accessed October 18, 2007).

[37] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

[38] Ibid.

[39] Ibid.

[40] Transactional Records Access Clearinghouse, "IRS 'Face-to-Face' Audits of Federal Income Tax Returns Filed by Individuals," Syracuse University, http://trac.syr.edu/tracirs/highlights/current/audpctcompare__ind.html (accessed October 16, 2007).



Unfortunately, the details behind the IRS data on increased audits tell a different story. Much of the increase cited by the IRS has been due to an emphasis on correspondence audits, not the more effective face-to-face audits. Overall, in fiscal year 2006, 77 percent of all audits—more than three out of four—were by correspondence.[41] What's more, correspondence audits—not face-to-face audits—have accounted for 74 percent of the recent increase in audits among high-income individuals.[42] Face-to-face audit levels have increased only modestly over that time.

This trend is problematic because correspondence audits are less effective than face-to-face audits, partly because this type of audit can only spot problems that are evident from information submitted by the taxpayer or from information reported by third parties (employers, banks, and other sources). For comparison, in fiscal year 2006, face-to-face audits on individual income tax returns for earners over $100,000 yielded an average of $54,934, while correspondence audits brought in $31,912.[43] For other types of tax returns, such as large corporations, the difference was even more dramatic. The average yield of a face-to-face audit for large corporations in fiscal year 2006 was $2.6 million, but correspondence audits of similarly sized companies averaged a meager return of $285,000.[44]

The IRS seems to have chosen to use correspondence audits so much mainly because administering them requires less staff time and resources. In fiscal year 2006, correspondence audits took an average of only 1.4 auditor hours each, drastically lower than the hundreds of hours face-to-face audits can take.[45] Indeed, IRS data shows even as overall audit rates have increased in the last few years, few additional staff have been added.

The IRS has decided, perhaps because of limited resources, to shift to less efficient and effective processes for auditing. If Congress and others in Government are serious about creating a robust tax enforcement system and closing the tax gap, additional resources are crucial. Increased funds could be used to raise staffing levels enough that IRS may gradually perform more high-yield face-to-face audits, which would have a greater impact on reducing the tax gap.

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[41] Transactional Records Access Clearinghouse, "Targeting of Correspondence Audit Improves," Syracuse University, http://trac.syr.edu/tracirs/newfindings/current (accessed October 16, 2007).

[42] Treasury Inspector General For Tax Administration, "Trends in Compliance Activities Through Fiscal Year 2006," U.S. Treasury Department, http://www.treas.gov/tigta/auditreports/2007reports/200730056fr.html (accessed October 16th, 2007).

[43] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

[44] Ibid.

[45] Transactional Records Access Clearinghouse, "Targeting of Correspondence Audit Improves," Syracuse University, http://trac.syr.edu/tracirs/newfindings/current (accessed October 17, 2007).

EXPAND INTERNAL TAX COLLECTION

Tax law enforcement does not end once an audit has been completed. The IRS will have to actively pursue unpaid taxes it identifies if they are not paid voluntarily. IRS collection officers may make an agreement with the taxpayer to pay the taxes, or issue levies, liens, or property seizures. Agents are also charged with identifying taxpayers who do not file a tax return and collecting the taxes owed. To do these things, significant staffing and resources are required.

Billions are lost annually because Congress does not sufficiently finance the IRS collection department. In 2002, former IRS Commissioner Charles Rossotti reported to the IRS Oversight Board that an annual investment of under $400 million in IRS collections could generate over $11 billion each year.[46] This additional funding could be used to hire more full-time employees to pursue cases the IRS has not taken action on due to insufficient personnel. Even without additional resources, NTA Nina Olson has recently stated the IRS can tackle many of those additional cases by implementing improvements to its current collection regimes.

Since Rossotti issued the 2002 report, activity in the collection function has increased modestly. Some key measurements have been on a steady upward trajectory, including the quantity of liens and levies issued by IRS collection staff.[47] However, the level of liens and levies is still down sharply from fiscal year 1996 levels, even excluding growth in the economy and tax returns. Some measures—such as the quantity of seizures—have not increased at all. Indeed, a 2007 Treasury Inspector General for Tax Administration (TIGTA) report found a robust collection function continues to be hampered by inadequate resources, as staffing for collection activities remains 30 percent below fiscal year 1997 levels.[48]

Wrong Strategy: Private Debt Collection

In 2004, Congress enacted—and in September 2006, the IRS implemented—a program to outsource the responsibility of collecting small tax debts to private debt collection firms. The principle rationale for creating the program was that its funding would not show up in the IRS budget. Although the Government still spends resources, using private collectors does not require additional annual appropriations. Under the program, private collectors get to keep a portion of the taxes they collect as payment. Therefore, given limited budgets, the IRS would be afforded an opportunity to collect taxes it otherwise could not.

However, the private tax collection program is wasteful and dangerous. Private collection agencies (PCAs) yield a return-on-investment (ROI) of 4:1, whereas—as former IRS Commissioner Mark Everson has acknowledged—Federal employees at the IRS produce a 13:1 ROI. Even more efficient, the IRS' Automated Collection System currently collects about $20 for every $1 spent on staffing, according to the NTA.[49]

Furthermore, despite claims the program has no costs, as of May 23, 2007, the IRS had spent $71 million in appropriated funding to set it up. If that money had instead been spent on those high-yield automated functions, an additional $1.4 billion in revenues could have been collected in just 1 year. Yet for all those missed opportunities, the private collection program is expected to yield only around $1.1 billion altogether over the next 10 years.

Initial data on the program are now available for the first year of operation, and the Washington Post has reported the PCAs averaged a 4.5:1 ROI, collecting $29 million, from which they were paid $6.34 million—far below both the IRS' ROI levels and initial revenue projections for the program.[50]

Regardless of the program's cost, many experts continue to worry PCAs might violate taxpayer rights. Olson has expressed a great deal of concern that profit-motivated companies could abuse taxpayers. According to Olson, PCAs have the opportunity to use "trickery, device, and belated Fair Debt Collection Practices Act warn-

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[46] Charles O. Rossotti, "Report to the IRS Oversight Board: Assessment of the IRS and Tax System."

[47] Transactional Records Access Clearinghouse, "IRS Collection Enforcement Trends," Syracuse University, http://trac.syr.edu/tracirs/highlights/current/collenfG.html (accessed October 16, 2007).

[48] Treasury Inspector General for Tax Administration, "Trends In Compliance Activities Through Fiscal Year 2006."

[49] National Taxpayer Advocate Service, "National Taxpayer Advocate's 2007 Annual Report to Congress," Internal Revenue Service, http://wwwrs.gov/advocate/article/0,,id=177301,00.html (accessed January 9, 2008).

[50] Business Section "Collectors Get $29 Million for IRS," Washington Post, January 9, 2008, http://www.washingtonpost.com/wp-dyn/content/article/2008/01/08/AR2008010804439.html.

ings to take advantage of taxpayers," and yet they are not obligated to disclose their "operational plans" regarding practices, letters, or scripts they will use.[51]

Indeed, anecdotal reports on the program's operations have borne out many of the concerns Olson voiced regarding abusive practices. At a May 23, 2007, hearing of the House Ways and Means Committee, Rep. John Lewis (D-GA) presented tapes of conversations between PCA employees and taxpayers.[52] Due to IRS privacy protections, PCA employees did not identify themselves, the nature of their business, or the purpose of their calls, and haggled with taxpayers to obtain their Social Security numbers. The taxpayers in the conversations refused to reveal their Social Security numbers and responded angrily when PCA employees asked repeatedly for the numbers but did not disclose the purpose of the conversations.

Olson reiterated her concerns about the ability of the program to operate efficiently and effectively in the recently released 2007 NTA report, stating tax collection is an inherently governmental function that should be handled only by Government employees trained to protect taxpayer rights. Olson argues the IRS could currently collect the outstanding debts given to the PCAs by improving its collection strategy and use of currently available resources, enabling the IRS to reach "most, if not all, of these cases [given to PCAs] at less cost to taxpayers and less risk to taxpayer rights."[53]

The sum of the evidence supports the need to shut down this program immediately. In 2007, Ways and Means Chairman Charles Rangel (D-NY) requested the IRS not issue any new contracts for the program, and the House passed a bill in October 2007 to end it entirely. This would be a wise change in IRS policy. Unfortunately, the IRS is moving forward with soliciting bids from additional PCAs for the second part of the program—full implementation. While Olson has pushed the IRS to include more transparency and taxpayer safeguards in the solicitation of new contracts, she continues to voice strong concerns and recommends Congress end the program.

Congress needs to act immediately to end this program and instead should make more resources available to the IRS to expand existing internal collection efforts.

INCREASE SERVICES FOR EITC TAXPAYERS

Re-establishing a robust auditing regime at the IRS is crucial to closing the tax gap. But focusing on enforcement at every turn, particularly having that focus land disproportionally on low-income taxpayers, is not the best solution. The IRS has taken an approach to overseeing and enforcing the Earned Income Tax Credit (EITC) that relies far too much on audits and not enough on services. This is unfair to those taxpayers who claim the EITC, who are held to a higher standard by the IRS than any other taxpayer group, and it fails to address EITC over-claims caused by errors, not malfeasance.

The EITC is a refundable tax credit for low-income workers. In tax year 2005, the EITC provided more than $41 billion to over 21 million families and individuals.[54] It lifts more working families out of poverty than any other work support; in 2003, the EITC helped raise 4.4 million people, including 2.4 million children, above the poverty line.[55]

Since it is a tax credit, the IRS administers the EITC and is responsible for maintaining its integrity. In 1999, the IRS estimated the EITC noncompliance rate at between 27 and 32 percent, resulting in between $8.5 to $9.9 billion annually in overpayments, or about 3 percent of the tax gap (though the NTA believes that rate is overstated).[56]

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[51] National Taxpayer Advocate Service, "National Taxpayer Advocate's 2006 Annual Report to Congress," Internal Revenue Service, http://www.irs.gov/advocate/article/0,,id=165806,00.html (accessed October 16, 2007).

[52] For a transcript of the tapes, see http://waysandmeans.house.gov/media/pdf/110/07%2005%2023%20Debt%20Collector%20call%20transcript.pdf.

[53] National Taxpayer Advocate Service, "National Taxpayer Advocate's 2007 Annual Report to Congress," Internal Revenue Service, http://www.irs.gov/advocate/article/0,,id=177301,00.html (accessed January 9, 2008).

[54] Center on Budget and Policy Priorities, "EIC Participation for Tax Year 2005, by State," http://www.cbpp.org/eic2008/docs/EIC%20participation%20prelim%20ty%202005.pdf (accessed October 17, 2007).

[55] Robert Greenstein, "The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor," Center on Budget and Policy Priorities, http://www.cbpp.org/7-19-05eic.htm (accessed October 17, 2007).

[56] Ibid.

Wrong Strategy: Punishing EITC Taxpayers

Mostly by congressional mandate, the IRS has taken a punitive approach to EITC error reduction. Congress designates a portion of the annual IRS budget specifically for EITC compliance. In fiscal year 2006, Congress allocated $167 million for EITC compliance, which the IRS used on several initiatives that focus disproportionate enforcement efforts on EITC taxpayers.

With this funding, Congress has instructed the IRS to heavily audit EITC taxpayers. Under the EITC compliance initiative in fiscal year 2006, almost 517,617 audits were performed on tax returns where the EITC was claimed. These audits constituted about 40 percent of all audits performed on individual tax returns in fiscal year 2006.[57] The examination rate for EITC recipients was 2.25 percent, compared to 1 percent for all individual income tax returns, and 1.3 percent of all individuals making over $100,000.[58] Yet EITC audits yield only a fraction of the total revenues recovered by IRS examinations. EITC audits identified nearly $1.5 billion in excess payments, resulting in a yield of only $2,895 per audit—the lowest rate of return for any type of audit performed by the IRS.[59]

Aside from a disproportionately large number of audits, EITC taxpayers are subject to a set of additional enforcement programs. First, the IRS applies a unique type of examination—called "recertification"—only to EITC taxpayers. The recertification program requires taxpayers to "recertify" if they had the EITC denied during an examination. This denial places recertification indicators on a taxpayer's account until the taxpayer proves he or she is eligible to receive the credit again. Once the taxpayer has provided sufficient evidence, he or she is deemed "recertified," and the taxpayer is once again eligible for the EITC. The number of taxpayers subject to this recertification tripled from 326,000 in September 1999 to almost 1 million by December 2003.[60] No other tax credit, deduction, or exemption requires such a high burden of proof.

The IRS has also put holds on millions of refunds to crack down on EITC errors. Beginning in 2005, the Criminal Investigations Division of the IRS began a program that postponed sending EITC refunds to people suspected of fraud. The NTA's 2005 Report to Congress revealed that of the 1.6 million taxpayers who had their refunds frozen, 75 percent were EITC recipients.[61] In 80 percent of the frozen refund cases brought to the NTA last year, the IRS ended up paying full or partial refunds, indicating a very large percentage of innocent filers had to face hardships resulting from delayed refunds.

Moreover, anecdotal evidence indicates the fear of punitive action by the IRS discourages workers from claiming the EITC. Currently, one in five workers who is eligible for the EITC does not claim it. Much of the energy and funding the IRS devotes to EITC compliance programs could be better spent by offering the helping hand of taxpayer services rather than punitive enforcement.

Expanded Assistance Would Reduce Error Rates

The EITC error rate could be significantly reduced by increasing the capacity of nonprofit or Government tax preparation services to assist EITC-eligible taxpayers.[62] EITC error rates do not distinguish taxpayers who intentionally cheated on their returns from those who simply made mistakes. EITC filings are complicated, requiring a 50-page instruction manual,[63] and therefore, many EITC overclaims are the result of mistakes that could be prevented. In fact, as much as 50 percent of all tax returns with errors are thought to be unintentional and have been linked to the complexity of EITC eligibility requirements.[64] These errors could be addressed principally by simplifying tax laws and, when necessary, giving taxpayers help in preparing what may unavoidably be a complicated application process.

Through its nationwide network of Taxpayer Assistance Centers (TACs), the IRS makes tax return preparation services available for low-income tax filers on a walk-

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[57] Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

[58] Ibid.

[59] Ibid.

[60] Treasury Inspector General for Tax Administration, "The Earned Income Credit Recertification Program Continues to Experience Problems," U.S. Department of Treasury, http://www.treas.gov/tigta/auditreports/2005reports/200540039fr.html (accessed October 17, 2007).

[61] National Taxpayer Advocate Service, "National Taxpayer Advocate's 2005 Annual Report to Congress," Internal Revenue Service, http://www.irs.gov/advocate/article/0,,id=152735,00.html (accessed October 17, 2007).

[62] Another effective approach is to simplify the credit. See Max Sawicky, "Where the Money Isn't," Economic Policy Institute, http://www.epinet.org/content.cfm/issuebriefs__ib183.

[63] See the IRS web site for the manual: http://www.irs.gov/pub/irs-pdf/p596.pdf.

[64] Max Sawicky, "Where the Money Isn't," Economic Policy Institute, http://www.epinet.org/content.cfm/issuebriefs__ib183 (accessed October 17, 2007).

in basis. Studies have found IRS-prepared returns from these centers are substantially more accurate than both self-prepared and commercially prepared returns.[65] Audits show that TAC-prepared EITC returns resulted in between $640–$1,300 less in erroneous payments than unprepared returns.[66]

Yet the IRS has decided to reduce the quantity and quality of services available at TACs. The number of tax returns TACs prepared declined from 665,868 in fiscal year 2003 to a projected 406,612 in fiscal year 2006.[67] A 2006 report by TIGTA also found more than 10 percent of TACs (47 of 400) were critically understaffed.[68] As the sheer volume of returns processed by TACs has decreased, the range of services they provide has also been narrowed.[69] For example, in North Dakota, where farming is a major industry, the TACs have been instructed not to answer questions related to reporting farm income on tax returns.[70] As more evidence of the detrimental combination of limited resources and unwise decisions at the IRS, employees at TACs have also been reassigned to jobs unrelated to taxpayer assistance, including being instructed to perform collection activities. This change diverts additional resources away from services offered at TACs.[71]

Even more worrisome, the IRS has also been attempting to close TACs. In 2005, the IRS announced plans to shut down 68 of the 400 TACs nationwide. Before the IRS could carry out these plans, Congress passed a bill prohibiting the IRS from closing the TACs until TIGTA could evaluate the potential impact the closures would have on taxpayers. In March 2006, TIGTA completed the report, which concluded the data concerning TAC usage, on which the IRS based its plans for TAC closures, was unreliable. IRS has so far delayed the closures.[72]

Dedicating additional resources to low-income services would have the benefit of reducing EITC error rates, closing the tax gap, and expanding needed services to more low-income taxpayers. At a minimum, the IRS and Congress should dedicate sufficient resources to maintain existing TACs. Even more funding would make the TAC network more responsive to taxpayer needs, both by opening more centers around the country and expanding the scope of services offered to taxpayers.

TAX ENFORCEMENT HAS TO BE A PRIORITY

The tax gap is an eminently solvable problem. If Congress were to prioritize funding for IRS examination, collection, and tax preparation services, it would drastically reduce the tax gap. The practical effect of expanding these activities at the IRS would be to make the tax code more equitable, and it would bring in additional revenue that could responsibly finance new programs and services. If implemented in the right way, closing the tax gap could also help to increase public confidence in the tax system and the Federal Government.

Congress needs to enact sustained increases in the IRS budget immediately and should make a commitment to continue to provide the IRS with the extra resources that are so crucial to effective tax enforcement.

This report has only highlighted a few sections of the IRS budget that merit additional funding and reforms. However, it refrains from specifying the dollar amounts needed to address these concerns and recommends a thorough congressional review of the entire IRS budget. We believe Congress, IRS administrators, and outside experts, upon whose research and expertise this report mainly relies, should come together to find common ground on what an appropriate funding increase would look like, how quickly it should be implemented, and how it could be sustained in coming years. Most experts, both inside the IRS and out, prefer gradual increases in fund-

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[65] Nina Olson, "The IRS and the Tax Gap," Testimony before the Committee on the Budget, U.S. House of Representatives, http://www.house.gov/budget__democrats/hearings/2007/08Olsontestimony.pdf (accessed October 16, 2007).

[66] Ibid.

[67] Nina Olson, "Hearing on Internal Revenue Service Fiscal Year 2008 Budget Request" Written Statement before the Subcommittee on Financial Services and General Government Committee on Appropriations, U.S. Senate, April 9, 2007.

[68] Treasury Inspector General for Tax Administration, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season But Challenges Remain for the Taxpayer Assistance Program." U.S. Department of Treasury, http://www.treas.gov/tigta/auditreports/2006reports/200640067fr.pdf (accessed October 16, 2007).

[69] National Taxpayer Advocate Service, "National Taxpayer Advocate's 2005 Annual Report to Congress," Internal Revenue Service. http://www.irs.gov/advocate/article/0,,id=152735,00.html

[70] Nina Olson, "Hearing on Internal Revenue Service Fiscal Year 2008 Budget Request."

[71] National Taxpayer Advocate Service, "National Taxpayer Advocate's 2005 Annual Report to Congress," Internal Revenue Service. http://www.irs.gov/advocate/article/0,,id=152735,00.html

[72] Treasury Inspector General for Tax Administration, "The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data." U.S. Department of Treasury, http://www.treas.gov/tigta/auditreports/2006reports/200640061fr.pdf (accessed October 16, 2006).

ing, as opposed to a sudden increase. A sudden increase would likely overwhelm the IRS and be implemented inefficiently and with too little oversight. Despite this recommendation, we believe the IRS funding shortage is an urgent matter and should be addressed as quickly as possible.

Ultimately, as with most fiscal issues, the root of the problem is political. The case must be made that fears of an IRS run amok are, in a way, a self-fulfilling prophecy. Attempting to curtail the powers of the IRS through inadequate funding levels has had unintended consequences—it has forced the IRS to institute policies and enforcement practices detrimental to tax collection, taxpayers' rights, and the progressivity of the tax code. So long as the IRS is underfunded, it will be forced to enforce the tax code unfairly and punitively. However, if the IRS is properly funded and administered correctly, the Federal Government will have the opportunity to make substantial progress in reducing the tax gap and to ensure the tax system is as progressive in practice as it is in law.

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. The IRS administers the tax laws and collects $2.4 trillion in revenue that fund over 96 percent of Federal Government operations. With approximately 90,000 employees, the IRS is effectively the accounts receivable department of the United States. Simply stated, the more revenue the IRS collects, the more revenue Congress may spend to either cut taxes, reduce the deficit, or advance important programs. And conversely, the less that is collected, the less revenue Congress has for these same purposes.

The IRS relies on three sources of funds it needs to operate: appropriated funds, user fees, and reimbursables, which are payments to the IRS which they receive from other Federal agencies and State government for services. Nearly the entire IRS budget, 97 percent of it, is derived from appropriated funds.

For fiscal year 2009, the Bush administration is asking a direct appropriation of $11.36 billion. It is an overall increase of $469 million, or 4.3 percent, above fiscal year 2008.

In addition to the request for appropriated funds in fiscal year 2009, the IRS also expects to realize nearly $108 million from reimbursable programs and $177 million in user fees, bringing total spending to $11.647 billion.

By breakdown of the nearly $11.4 billion appropriation requested, $2.15 billion is for taxpayer services; $5.12 billion for enforcement; $3.86 billion for operations support; $222.7 million for business system modernization; and $15.4 million for health insurance tax credit administration.

As the subcommittee evaluates the President's request, we will take stock of the recommendations of the Oversight Board and a lot of experts. I know the Oversight Board is tasked by law to review and assess the annual budget request for the IRS to make sure it supports the agency's annual and long-term strategic plans.

Before we hear our panelists, I would like to mention just a few of the issues we will be considering.

First, how does the proposed budget address the tax gap? The great majority of Americans pay their fair share of taxes, but there is still a significant tax gap. That is the difference between what taxpayers are supposed to pay and what they actually pay. I note that as part of its budget submission, the IRS proposes 16 legislative reforms to recoup $36 billion of the $290 billion net tax gap over the next 10 years.

Questions have been raised that such an approach is not aggressive enough and amounts to a return of just slightly over a penny

on the dollar. I am anxious to hear perspectives from our panel members.

Second, does this proposed budget achieve the proper balance between enforcement and service? It is fundamental that as enforcement initiatives to boost compliance are advanced, resources for taxpayer services not be sacrificed. Taxpayer service plays an integral role in facilitating voluntary compliance.

Third, does the proposed budget promote critical investments and ensure meaningful progress in information technology enhancements? Let me just say that we know that the IRS is facing, in addition to the regular tax return filing season, the issuance of $100 billion in stimulus payments in the form of rebate checks over the next few months. I understand that as of March 28, the IRS received an estimated 1.4 million tax returns from individuals who filed them solely to receive the rebates. I also understand the IRS has been receiving an average of more than 63,000 calls per day above the normal volume asking questions about the rebates.

Let me just say there are many topics of concern that we will go into in the hearing, but in the interest of moving it along, I am going to ask my colleague, Senator Allard from Colorado, if he has an opening statement or a comment that he would like to make.

Senator ALLARD. I do, Mr. Chairman, just brief comment, if I might.

Senator DURBIN. And when he is finished, we will proceed with questions.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman, for holding today's hearing. I would like to thank our panelists for joining us this afternoon.

For some time now, I have been following closely and showing some concern on the IRS's ongoing audit process involving the conservation easement donations in Colorado. I understand Colorado is one of the top States in the number of conservation efforts that it has undertaken, and it is an issue of great importance to our State and many people in it and our quality of life as far as our goals for open space. And I support the IRS investigation and enforcement of legitimate fraud in an effort to route out abuse of the conservation easements tax credit program.

However, at times I wonder if the IRS has wrongly targeted honest and hardworking Coloradans throughout their investigation. I hope that they would refocus its investigation and approach the issue in a fair and reasonable manner. There are at least 96 audits involving donations to mainstream conservation organizations that follow the letter and the spirit of the law, I believe. Some of the 96 donations were verified by legitimate conservation easements by the U.S. Department of Agriculture and other Government agencies, I am led to believe.

I would urge you to follow the model set by Colorado and refocus on cases involving an appraiser or land trust who has been disciplined or is currently under investigation by the State. Hopefully, this approach will rightly target the actual abuse, while releasing lawful easement donations from multiyear, stressful, and unjustified audits.

So we will be following this particular area closely, Mr. Chairman. My office has been contacted by a number of organizations that work with these easements. And I would encourage the Internal Revenue Service on their investigations to use common sense in their approach, and I understand that there are violations and there have been reasons why you have had to look at some of these deals in Colorado. But on the other hand, we hope that we do not get too broad and snare and tie up innocent parties that perhaps did not violate the law.

So thank you very much, Mr. Chairman.

Senator DURBIN. Thank you, Senator Allard.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

Thank you, Mr. Chairman, for holding today's hearing. I would also like to thank our panelists for joining us this afternoon.

For some time now I have been involved and concerned by the IRS' ongoing audit process involving conservation easement donations in Colorado. Colorado is a national leader in conservation, and it is an issue of great importance to our state's economy and quality of life.

I support the IRS' investigation and enforcement of legitimate fraud in an effort to root out abuse of the conservation easement tax credit program. However, I feel the IRS has wrongly targeted honest and hard working Coloradoans throughout their investigation.

I hope the IRS would refocus its investigation and approach the issue in a fair and reasonable manner. There are at least 96 audits involving donations to mainstream conservation organizations that follow the letter and spirit of the law. Some of these 96 donations were verified to be legitimate conservation easements by the U.S. Department of Agriculture and other Government agencies.

The IRS should follow the model set by Colorado and refocus on cases involving an appraiser or land trust who has been disciplined or is currently under investigation by the State. This approach will rightly target the actual abuse while releasing lawful easement donors from multi-year, stressful, and unjustified audits.

If the IRS decides not to alter the ongoing audit process they and the hard-working taxpayers can expect a long drawn-out battle. If they stay on their current course, the IRS may be faced with over 200 appeals. This many appeals will take a lot of time and resources to build a case for every easement in question. At what cost? The American taxpayers are on the hook for this process that has been going on for several years already and there is no end in sight.

There is a significant need for conservation easements in Colorado and a few abuses should not end the charitable tax credit for everyone.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Brownback.

STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Thank you very much, Mr. Chairman. I appreciate this.

Welcome, Commissioner. Glad to have you here, 4 weeks onto the job. Yesterday, I guess, was your big day. The rest of us were not celebrating yesterday. But delighted to have you here and in that job and position.

I do want to make a point about yesterday, and I appreciate the hearing, appreciate you being here on our budget. But I was noting in my opening remarks that on the complexity of the Tax Code, you have 800 different IRS tax forms—800. And I do not know if any one person fills out all 800 of them. If they fill out 100 of them or if they fill out 50, this is an unbelievably complex Tax Code. That is your problem to enforce, but that is our problem in the creation

of it. And as I just pointed out I think we are well overdue for tax simplification.

You are only 4 weeks into a job, but it is a 5-year appointment, and I would hope that over the period of time that you are Commissioner, that you really help us work on tax simplification and that you become an advocate for it. I mention that you note there is a part of your enforcement problem that is involved the so-called tax gap. In your congressional budget justification, you state that a major contributing factor to the tax gap is that our tax system is so complex that taxpayers cannot figure out what they owe. So a big part of your enforcement problem is taxpayers not being able to figure out which of the 800 forms they are supposed to fill out. That is why I really think we have got to look at tax simplification.

I have put forward a proposal, an optional flat tax, leave the Code in place, but let people choose a simpler system. And I do not expect you to put a proposal forward in the short term while you are in, but I do hope during the time that you are Commissioner you really help us wrestle with that problem. It will make your job a lot simpler. I think it will be well received across the country, that they want to see a simpler, fairer, flatter system, and I would hope that we could learn in your position to get a Code that is a lot easier for people to understand and a lot easier to enforce too.

Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Good afternoon. I want to thank you, Chairman Durbin, for your leadership on this subcommittee. As always, I look forward to working with you during this coming year as we make funding decisions and provide oversight to the various agencies within this subcommittee's jurisdiction.

Commissioner Shulman, thank you for appearing before our subcommittee today. I understand you have only been with the IRS a few weeks, so this is certainly a busy time for you to be taking the reins. I'm pleased we have such a highly qualified person in the job and I look forward to hearing the details of your fiscal year 2009 budget request. Your budget justification says that the IRS "represents the face of the U.S. government to more American citizens than any other agency." As surprising as it may seem in Washington, many Americans only come into direct contact with the Federal Government on Tax Day. I appreciate the work that you and your staff do to ensure taxpayer compliance and to provide taxpayer assistance.

I must take this opportunity, though, to express my deep concerns about the current tax system. Yesterday was a dark day for most Americans as they rushed to file their tax returns. Every year, taxpayers suffer under the burden of our complex and complicated tax code, confused by over 800 different IRS tax forms, perplexed by hundreds of pages of IRS instruction books, and nervous that they will make a mistake trying to calculate how much of their money they owe the Federal Government.

This current maze of tax regulations is so convoluted and complex that many Americans believe it is not only incomprehensible, but unfair. This confusion is one reason why almost two-thirds of all taxpayers have given up on trying to figure out how to complete their own tax returns and now spend even more of their hard-earned wages to pay someone else to sort it all out.

I'm not blaming you for this state of affairs, Commissioner Shulman. Lawmakers have created this labyrinthine maze and you and your people are just working to administer it.

Looking at the President's budget request, I am pleased that it includes a 7 percent increase for taxpayer enforcement to work toward closing the so-called "tax gap." Certainly, we must ensure that taxes which are owed are collected. But your own congressional budget justification states that a major contributing factor to the "tax gap" is that our tax system is so complex that taxpayers cannot figure out what they owe. I have been informed that the annual tax gap is about $290 billion. I'm glad to see that the IRS is devoting resources to closing this gap, but I believe that

as long as we have this convoluted and burdensome system, the gap between taxes owed and taxes paid will remain substantial.

Again, Commissioner Shulman, this system is one that you have inherited. I am in no way blaming you for this state of affairs. But I have to take this opportunity to continue to push for an optional flat Federal income tax. A flat tax would be a clear and fair way for American families to figure out what they owe and put it on a one-page form to the Federal Government. As long as a flat tax rate is reasonable, it is a fairer tax than the current system because it taxes all earned income at the same rate. Workers would not be punished for working harder and earning more money, because each dollar that they earn would be taxed at the same exact rate. This would be fairer, simpler, easier to understand, and would produce more economic activity and jobs.

Finally, I am pleased that Americans will soon be receiving economic stimulus checks in the mail. I certainly support these tax rebates to hard-working families. But the complexity of the tax system was again evident when the IRS recently had to hold a "Super Saturday," opening hundreds of IRS offices to help folks file their returns so that they could receive their economic stimulus payments. In fact, your agency must spend over $2 billion every year just to help people figure out how to complete their tax returns. Quite frankly, that says it all.

So Commissioner Shulman, I thank you for your service and I look forward to hearing your testimony this afternoon.

Thank you, Mr. Chairman.

STATEMENT OF IRS COMMISSIONER DOUGLAS SHULMAN

Senator DURBIN. Thanks a lot.

Commissioner Shulman, the table is yours for a 5-minute statement. All the rest will be put in the record. And welcome.

Mr. SHULMAN. Thank you, Chairman Durbin, Ranking Member Brownback, Senator Allard. I appreciate the opportunity to appear here before the subcommittee. As you have noted and noticed, I am in my fourth week on the job. Let me reiterate to this subcommittee that I look forward to working with you during my entire tenure here to address the critical issues related to the IRS.

I would also like to introduce the IRS's two Deputy Commissioners, Richard Spires and Linda Stiff, who are here with me today. They have really done an excellent job guiding the agency through what, by any measure, are some tough times: this filing season, the late enactment of the alternative minimum tax (AMT) legislation, and then the stimulus package. I am lucky to have them on the team. I also wanted to make sure we are responsive to any questions and given that I am 4 weeks into this, I wanted to make sure they were here with me today.

This morning I will touch quickly on the filing season and our proposed budget, but I will also try to give you a little sense of my approach to the job.

Yesterday we completed what looks like a successful filing season. Electronic filers were up 10 percent as of yesterday. The number of returns prepared by our volunteer income tax assistance and tax counseling for the elderly centers throughout the country were up 26 percent. The usage of our Free File program, which allows 70 percent of all Americans to prepare and file their returns electronically, was up 20 percent this year. And visits to IRS.gov were up 21 percent.

We also, as I mentioned, are having a successful filing season despite some pressures, including late enactment of the AMT and, as you mentioned, Mr. Chairman, the stimulus program which was put on top of filing season.

Regarding the stimulus program, we have done an extensive outreach program to make sure Americans know that all they need to do is file a tax return in order to get a stimulus payment. We put particular emphasis on informing Americans who normally would not file a return, but are eligible for stimulus payments, that they need to file a return this year. These are people who receive Social Security, receive veterans benefits, low income workers.

I also want to urge this subcommittee to support full funding of the IRS's 2009 budget request. This budget will allow us to continue a strong emphasis on taxpayer service, but also to continue to build on our good record of enforcement programs to target noncompliance.

During my confirmation process, I was asked by the Senate Finance Committee whether I thought it was most important to focus on service or to focus on enforcement. And my answer there—and I fervently believe this—is that for the IRS to achieve its compliance objectives, we have to continue to focus on both service and enforcement. Said another way, I think we need to do everything we can to make it as seamless and easy as possible for taxpayers who want to pay the right amount of taxes to navigate our organization, get their questions answered, pay their taxes, and get on their way. But for anyone who understands his or her tax obligation and is trying to evade that obligation, we need to have aggressive enforcement programs.

Another area of focus for me will be technology modernization. The evolution of technology has changed the way that every major organization, private and public, goes about doing its work. As we adapt to this changing world, my goal is relatively simple. It is to get the right information into the hands of the right people at the right time, whether that is getting information into the hands of taxpayers or our people trying to do service or enforcement.

The other area I would mention quickly is our need to continue to focus on leadership and workforce. The IRS, like other Government agencies, is going to have a lot of people retiring in the next couple of years. There is competition for talent, and we are going to need to keep focusing on building our next generation of leaders and developing our workforce.

PREPARED STATEMENT

So let me thank you again, Mr. Chairman, for the opportunity to appear this morning. In my short tenure, I have found the people at the IRS to be extremely professional, hardworking, and dedicated to the American people every day. I am committed to work every day to provide the level of service that taxpayers deserve, as well as to rigorously enforce the tax laws. We obviously need resources to execute this mission, and I encourage this subcommittee to fully fund the administration's 2009 proposed budget. Thank you, and I am happy to answer questions.

Senator DURBIN. Thanks, Mr. Commissioner.

[The statement follows:]

PREPARED STATEMENT OF DOUGLAS SHULMAN

INTRODUCTION

Chairman Durbin, Ranking Member Brownback, and members of the subcommittee, thank you for the opportunity to appear today. This is my third hearing as the IRS Commissioner and I look forward to working with the Members of this subcommittee in the future as we address issues related to the IRS.

As I settle in to my new role, it becomes clearer to me each day what a privilege it is to be the Commissioner of the IRS. The IRS and its employees represent the face of United States Government to more American citizens than any other Government agency. We administer America's tax laws and collect over 96 percent of the revenues that fund the Federal Government each year.

My most recent experience has been as the Vice Chairman of the Financial Industry Regulatory Authority (FINRA), formerly the NASD. In 2007, NASD consolidated with the member regulation, enforcement, and arbitration functions of the New York Stock Exchange to form FINRA. Based on my previous experience, I believe that leaders of large organizations—public and private—always must be focused on ensuring that resources are aligned with strategic priorities. It is incredibly important that there be a balance of resources between day-to-day execution and investments for the longer term. In my first 4 weeks, I have been working with the senior executive team of the IRS to understand how resource allocation decisions have been made. The subcommittee can expect ongoing dialog and personal engagement from me on these issues.

2008 FILING SEASON

The biggest challenge the IRS faced at the end of 2007, as it approached the 2008 filing season, was the uncertain status of legislation to address the situation of an additional 21 million taxpayers who otherwise would have become subject to the alternative minimum tax (AMT).

On October 30, 2007, Chairman Baucus, Ranking Member Grassley of the Senate Finance Committee House and their counterparts on the House Ways and Means Committee, sent a letter assuring the IRS that Congress intended to enact AMT relief (the AMT patch) in a manner acceptable to the Senate, the House of Representatives, and the President. I am told that this letter was very helpful because it allowed the IRS to move forward on certain planning and design aspects of implementing the AMT relief legislation, shortening the implementation process by a number of weeks.

However, the IRS indicated at the time that its key systems could accommodate only one programming option without introducing excessive risk to the filing season. As a result, the IRS was able to proceed only so far without actual legislation being enacted. When the President signed the AMT relief law on December 26, 2007, the IRS immediately began the detailed reprogramming of systems to accommodate the new law. IRS employees worked diligently to modify systems to implement the changes in a very short time period. My thanks go out to all of those dedicated employees who worked almost around the clock to enable us to implement this AMT relief legislation in record time.

Given their efforts, we were able to begin the filing season on schedule for most taxpayers. However, the processing of returns filed by approximately 13.5 million taxpayers that included one of five forms associated with the AMT legislation was delayed. These taxpayers had to wait until February 11, 2008, before their returns could be processed.

The other challenge facing us this filing season is the implementation of the economic stimulus package enacted in early February, specifically the planning for the distribution of the stimulus payments to eligible recipients throughout the country this spring. To deliver the 2008 stimulus payments, we have been programming our systems to calculate the appropriate amount for each eligible taxpayer based on their 2007 returns so that the payments can be distributed, through Treasury's Financial Management Service, by direct deposit or by paper check, based on the preferences expressed on the taxpayer's return.

We will begin immediately after the close of the filing season to distribute those payments with the expectation that the first payments will be sent electronically starting in the first week of May and with the first paper checks being mailed shortly thereafter. We have established a distribution schedule that is published on the IRS website on a page dedicated to informing citizens about the economic stimulus payments.

However, there are millions of individuals who may be eligible for economic stimulus payments, but who typically do not have an income tax filing requirement. This

group includes retirees or those who have minimal income and are thus not required to file. But in order to receive the 2008 stimulus payment, the recipient must file a tax return for 2007. To reach these recipients and educate them requires an extensive outreach program that includes the mailing of information packets and IRS coordinating with the Social Security Administration and Department of Veterans Affairs, along with private groups such as the AARP.

Despite the challenges presented by the late enactment of the AMT patch and the implementation of the economic stimulus payments, I am proud to report that thus far the filing season has gone very well. Allow me first to give an update on some of the numbers we are looking at as we close out the filing season.

Numbers Thus Far

We expect to process nearly 140 million individual tax returns in 2008, and we anticipate continued growth in the number of those that are e-filed. In the 2007 filing season, almost 60 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of April 5, we have received over 67 million tax returns electronically, an increase of 10 percent compared to the number of returns that were e-filed during the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by 18.2 percent compared to the number of self-prepared returns filed during the same period a year ago. Over 19 million returns have been e-filed by people from their personal computers, up from just over 17 million for the same period a year ago.

Overall, nearly 70 percent of the returns filed through April 5 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in 2 weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error-reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds deposited directly into their bank account than ever before. As of April 5, we have directly deposited over 53.6 million refunds, or over 71 percent of all refunds issued this tax filing season.

People are also visiting our web site—IRS.gov—in record numbers. We have recorded over 132 million visits to our site this year, up over 21 percent from 109 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the IRS.gov web site. The web site:

—Allows taxpayers to obtain information on the economic stimulus package including determining the payment amount they can expect to receive and learning when they can expect their payment based on their Social Security Number (SSN);

—Assists taxpayers in determining whether they qualify for the Earned Income Tax Credit (EITC);

—Assists taxpayers in determining whether they are subject to the Alternative Minimum Tax (AMT);

—Allows more than 70 percent of taxpayers the option to prepare and file their tax returns at no cost through the Free File program. This includes giving a free option for those taxpayers who normally do not file a tax return, but are required to this year in order to receive their stimulus payment;

—Allows taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and

—Allows taxpayers to calculate the amount of their deduction for State and local sales taxes.

We have issued 75.1 million refunds as of April 5, for a total of $183 billion. The average refund thus far is $2,436. In addition, nearly 28 million taxpayers have tracked their refund on IRS.gov, up nearly 20 percent over last year.

As of March 29, our Taxpayer Assistance Centers (TACs) are reporting over 2.1 million taxpayers assisted. Our telephone assistors have answered over 13 million calls, and over 17 million callers received automated services.

Free File

Over 3.6 million people have utilized Free File as of April 5, 2008, an increase of 19.7 percent compared to the number of taxpayers that used Free File during the same period a year ago. This year anyone with adjusted gross income of $54,000 or less is eligible for Free File, which includes 97 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing, and we expect to meet or exceed 2007 totals by the end of the filing season. One reason

for this increase is that we have committed additional resources to promote the Free File program.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased over the years. In 2007, over 2.6 million returns were prepared by volunteers. As of April 5, 2008, volunteer return preparation is up over 26 percent compared to the number of volunteer-prepared returns filed during the same period a year ago. This is reflective of continuing growth in existing community coalitions and partnerships.

We also have made a concerted effort to expand outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored again this year EITC Awareness Day on January 31, 2008, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit. Over 125 coalitions and partners hosted local news conferences and issued more than 100 press releases highlighting EITC Awareness Day this year.

A COMMITMENT TO SERVICE, ENFORCEMENT AND MODERNIZATION

I understand that in fiscal year 2007, the IRS continued making improvements in our service and enforcement programs as well as having significant successes in our IT modernization program. A few highlights of the IRS' fiscal year 2007 accomplishments include:

—The IRS customer assistance call centers answered 33.2 million assistor telephone calls and 21.1 million automated calls. We maintained an 82.1-percent level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions.

—Outreach and educational services were enhanced through partnerships between the IRS and public organizations. Through its 11,922 VITA and TCE sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. Over 76,000 volunteers filed 2.63 million returns for these individuals. Additionally, the IRS established 6 new tax clinics in rural areas to help low-income taxpayers meet their tax obligations.

—Enforcement revenue has risen from $33.8 billion in fiscal year 2001 to $59.2 billion, an increase of 75 percent. These numbers do not include the deterrent effect that an increased enforcement presence has on voluntary compliance.

—Both the levels of individual returns examined and coverage rates have risen substantially. The IRS conducted nearly 1.4 million examinations of individual tax returns in fiscal year 2007, an 8-percent increase over fiscal year 2006. This level of examinations is over three-quarters more than were conducted in fiscal year 2001, and reflects a steady and sustained increase since that time. Similarly, the audit-coverage rate has risen from 0.6 percent in fiscal year 2001 to 1 percent in fiscal year 2007. This increase was achieved without a significant increase in resources as compared to the previous fiscal year.

—The Customer Accounts Data Engine (CADE) Release 3.2 was delivered on time (January 14, 2008) for this filing season and is doing well in production. As, of April 11, CADE had processed 24.98 million returns, which is more than 25 percent of all individual returns filed to date for this year. CADE also has issued almost $38 billion in tax refunds.

—Modernized e-File (MeF) is the IRS designated e-File platform (electronic filing system) for the future and provides e-Filing capability for large corporations, small businesses, partnerships, and non-profit organizations. As of April 5, MeF has accepted 1.82 million corporate, partnership, and tax exempt tax returns, a 45-percent increase from this same period a year ago. MeF Release 5 went into production as planned in January 2008 and provides the ability to file electronically Form 1120F (tax returns for foreign corporations) and Form 990N (so-called electronic postcard for small tax-exempt organizations to meet their filing requirement).

THE ADMINISTRATION'S FISCAL YEAR 2009 BUDGET FUNDS TAXPAYER SERVICE AND ENFORCEMENT

The fiscal year 2009 budget request funds activities that promote better tax administration and compliance with the tax laws. The fiscal year 2009 budget request for the enforcement program is $7,487,209,000, an increase of $489,983,000, or 7 percent, over the fiscal year 2008 enacted level. The Administration proposes to in-

clude these enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The enforcement program is funded from the Enforcement appropriation and part of the IRS Operations Support appropriation.

Budget Request

For fiscal year 2009, the President is requesting a total of $11,361,509,000 for IRS activities. This amount is a $469,125,000 increase, or 4.3 percent, over the fiscal year 2008 enacted level.

The overall IRS budget is broken down into the following five appropriations:

—*Taxpayer Services*.—The fiscal year 2009 requested level for this area is $2,150,000,000. This is the same as the fiscal year 2008 enacted level. The Operations Support account provides an additional $1.5 billion to support taxpayer service activities.

—*Enforcement*.—The fiscal year 2009 request is $5,117,267,000. This level is an increase of 7.1 percent from the fiscal year 2008 enacted level. As mentioned earlier, the Operations Support budget provides an additional $2.4 billion to support enforcement activities.

—*Operations Support*.—The fiscal year 2009 request is $3,856,172,000. This level is an increase of 4.8 percent from the fiscal year 2008 enacted level.

—*Business Systems Modernization*.—The fiscal year 2009 request is $222,664,000. This level is a reduction of 16.6 percent from the fiscal year 2008 enacted level. This appropriation funds the planning and capital asset acquisition of information technology to modernize the IRS business systems, including labor and related contractual costs.

—*Health Insurance Tax Credit Tax Administration*.—The fiscal year 2009 request for this program is $15,406,000. This is an increase of 1.1 percent from the fiscal year 2008 enacted level. This appropriation funds costs to administer a refundable tax credit for health insurance to qualified individuals, which was enacted as part of the Trade Adjustment Assistance Reform Act of 2002.

The justification for the requests in each of these areas is discussed in detail below.

Adjustments from Fiscal Year 2008 Levels To Help Improve Compliance

The IRS total requested funding increase for fiscal year 2009 is $469,125,000. This increase will go to improving compliance. These investments fund increased front-line enforcement efforts, enhanced research, and implementation of legislative proposals to help narrow the tax gap. By fiscal year 2011, these investments are projected to increase annual enforcement revenue by $2 billion. In addition, the legislative proposals included in the fiscal year 2009 budget to improve tax compliance are estimated to generate $36 billion over the next ten years, if enacted.

Specific increases to improve compliance include:

—*Reduce the Tax Gap for Small Business and the Self Employed (+$168,498,000/+1,608 FTE)*.—This enforcement initiative will increase enforcement efforts to improve compliance among small business and self-employed taxpayers by: increasing audits of high-income returns, increasing audits involving flow-through entities, implementing voluntary tip agreements, increasing document-matching audits, and collecting unpaid taxes from filed and non-filed tax returns. This request will generate $981 million in additional annual enforcement revenue once new hires reach full potential in fiscal year 2011.

—*Reduce the Tax Gap for Large Businesses (+$69,488,000/+519 FTE)*.—This enforcement initiative will increase examination coverage of large and mid-size corporations, including multi-national businesses, foreign residents, and smaller corporations with significant international activity. It also will enable the IRS to use existing systems further to capture other electronic data through scanning and imaging. The initiative will allow the IRS to address risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for non-compliance is significant. Funding of this request will generate $544 million in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2011.

—*Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance (+$51,058,000/+393 FTE)*.—This enforcement initiative will support and expand ongoing research studies, including the National Research Program, of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to target better specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Improved research data will be used to refine workload selection models, reducing audits of compliant taxpayers.

—*Increase Reporting Compliance of U.S. Taxpayers with Offshore Activity (+$13,697,000/+124 FTE).*—This enforcement initiative will address domestic taxpayer offshore activities. Abusive tax schemes, under-reporting of flow-through income, and certain high-income individuals are prime channels or candidates for tax evasion. This initiative will focus on uncovering offshore credit cards, disguised corporate ownership, and brokering activities in order to identify individual taxpayers who are involved in offshore arrangements that facilitate noncompliance. Funding of this request will generate $102 million in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2011.

—*Expand Document Matching (+$35,060,000/+413 FTE).*—This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program. This program matches third-party information returns (e.g., Form W–2 and Form 1099 income reports) against income claimed on tax returns. When potential underreporting is discovered taxpayers are contacted to resolve the issue. This request will produce $359 million in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2011.

—*Implement Legislative Proposals To Improve Compliance (+$23,045,000/0 FTE).*—While the IRS continues to address compliance by improving customer service and using traditional methods of enforcement, the fiscal year 2009 budget also includes legislative proposals that would provide additional enforcement tools to improve compliance. It is estimated that these proposals, if enacted, will generate $36 billion in revenue over 10 years (see the Treasury Blue Book, available on the Treasury Department web site, for more information). The proposals would expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS IT systems necessary to implement the proposals. The specific legislative proposals are discussed below.

Specific Legislative Proposals

The Administration's fiscal year 2009 budget includes a number of legislative proposals intended to improve tax compliance while minimizing the burden on compliant taxpayers as much as possible. These include:

—*Expand information reporting.*—Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would:
  —Require information reporting on payments to corporations;
  —Require basis reporting on security sales;
  —Require information reporting on merchant card payment reimbursements;
  —Require a certified Taxpayer Identification Number (TIN) from contractors;
  —Require increased information reporting on certain Government payments;
  —Increase information return penalties; and
  —Improve the foreign trust reporting penalty.

—*Improve compliance by businesses.*—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
  —Require electronic filing by certain large organizations; and
  —Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes.

—*Strengthen tax administration.*—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
  —Expand IRS access to information in the National Directory of New Hires for tax administration purposes;
  —Permit disclosure of prison tax scams;
  —Make repeated willful failure to file a tax return a felony;
  —Facilitate tax compliance with local jurisdictions;
  —Extend statutes of limitations where State tax adjustments affect Federal tax liability; and
  —Improve the investigative disclosure statute.

—*Expand penalties.*—Penalties play an important role in discouraging intentional non-compliance. A specific proposal to expand penalties would impose a penalty on failure to comply with electronic filing requirements.

Improve Tax Administration and Other Miscellaneous Proposals

The Administration has put forward additional proposals relating to IRS administrative reforms. Five of these proposals are highlighted below:

—The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.
—The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.
—The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.
—The fourth proposal extends the IRS authority to use the proceeds received from undercover operations through December 31, 2012. The IRS was previously authorized to use proceeds it received from undercover operations to offset necessary and reasonable expenses incurred in such operations. This authority expired on December 31, 2007.
—The fifth proposal equalizes penalty standards between tax return preparers and taxpayers, reducing unnecessary conflicts of interest between them. The standard applicable to tax return preparers for undisclosed positions would be "substantial authority" but for certain reportable transactions with a significant purpose of tax avoidance, the existing standard would persist (i.e., the preparer should have a reasonable belief that the position, more likely than not, would be sustained on the merits).

CONCLUSION

Thank you again, Mr. Chairman, for the opportunity to appear this morning and update the subcommittee on the filing season and the fiscal year 2009 proposed IRS budget. In my short tenure, I have found IRS employees to be professional, hard-working, and dedicated.

I am committed to working hard everyday to provide taxpayers the high level of service they deserve and to pursue enforcement actions against those unwilling to meet their tax obligations.

We need resources to execute against our plan, and I hope this subcommittee will support the full funding of the Administration's fiscal year 2009 proposed budget.

I also urge this subcommittee to support the enactment of the legislative proposals included in the budget to improve compliance. Collectively, they will generate more $36 billion over the next 10 years if enacted.

I will be happy to respond to any questions.

CONTRACTORS

Senator DURBIN. In preparation for this hearing, I am hoping that you have read Parade magazine in last Sunday's newspaper because my first question relates to enforcement and an article in that Parade magazine. It was under their so-called intelligence report entitled "Are You Paying for Corporate Fat Cats?" 61 percent of U.S. corporations paid no taxes, including 39 percent of large companies, according to this article. They went on to describe one company in particular, which I would like to ask you about.

It turns out that one company employs one-third of our private contractors in Iraq. That company is Kellogg, Brown & Root (KBR), a former subsidiary of Halliburton. The company has 54,000 people working in Iraq. Of these, over 21,000, including 10,500 Americans, are considered Cayman Island hires. What has happened is that this company has created some subsidiaries or offices in the Cayman Islands, and by listing these employees paid by our Government as Cayman Island hires, they avoid paying the Medicare and Social Security taxes that all other American workers pay.

So here we have Federal taxpayer dollars, emergency appropriations adding to our deficit to fund the private contractors who are being channeled through the Cayman Islands so that they will not

have to pay taxes into the United States for Medicare and for Social Security. I want to know if the IRS is looking into it, and I want to know what more we can do to try to stop this.

Mr. SHULMAN. Thank you for the question. Let me just state before I start, I obviously cannot speak about any specific taxpayers or any tax matters because of privacy laws. Let me just react on a general level, and then we would be happy to follow up.

We are well aware and focused on the issue of independent contractors. Employment taxes are one of our responsibilities. Any issue with employment taxes is very fact-specific. We have a 20-point factor test that gets into the specific facts of a case. It is difficult for corporations and us to work through these issues, but we have a number of investigations ongoing in relation to employment taxes and subcontractors, and we view that as part of our job.

I would also mention something I have spoken about publicly is that one of the challenges of our next 5 years is going to be grappling with the global economy, globalization, international tax issues. I have sat down with our team that focuses on these areas. I am quite familiar with these issues from my experience as a securities regulator and the global flow of capital. So issues around cross-border trade, employees located in multiple countries, paying the proper amount of U.S. taxes is something that is going to get focus from me.

Senator DURBIN. And I might say that it is not just KBR. A 2004 study by the Government Accountability Office found that 24 of the largest Federal contractors, contractors we pay by our Government, use the Cayman Islands to shave their tax bills. This bothers me that American companies doing the right thing are being penalized and other companies are profiting simply because they are creating these phony tax havens like the Cayman Islands.

PRIVATE DEBT COLLECTION

Now let us talk for a minute about an issue that you have been asked a lot about, and that is this private collection agency for the IRS. This has been in place for a while now, these private debt collectors. There are several of them across the country, and they are not doing a very good job. If you take a look at our own IRS employees collecting taxes, the return on investment for taxpayers is 13 to 1. For the private collectors, it is only 3 to 1. To date, after spending $71 million on startup and ongoing maintenance costs through the end of fiscal year 2007, the IRS private tax collection program has lost us $50 million.

Why should we continue this?

Mr. SHULMAN. This is an issue that I understand quite well has a lot of attention, and there are people who support the program and detractors from the program. I have committed to get my arms around this. As you can imagine, there are a variety of programs, most programs, that I still need some time to get up to speed on, and I am going to spend time getting up to speed on this.

What I will tell you is I know the program has been authorized in the past by Congress. I have been told by the people at the IRS that they are working this program to the best of their abilities. We are very focused on the protection of taxpayer rights and data privacy. This year the program will do better than break even, and

so there are variety of sunk costs that have not been recovered, but it is now at a point where it actually is bringing dollars into the Federal coffer.

So on this one, I would say I plan on looking at it closely and studying the issue and would be happy and like to have further conversations.

Senator DURBIN. Thank you.

FORMS AND COMPLEXITY

Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman.

Do you really need 800 different forms?

Mr. SHULMAN. As we have had a chance to discuss, clearly the tax law is complex. Clearly, that adds burden on the American people and makes our job difficult. I cannot speak to all the specific forms 4 weeks into the job.

I will tell you a goal of mine is to create as much clarity as we can within the context of the law to the American people, make it as easy as possible, given the complexity of the law, for the American people to comply with their tax obligation.

Senator BROWNBACK. I hope you will look at that. That is just mind-boggling to me.

I was just looking at the numbers that were just handed to me. The IRS spends $2 billion on taxpayer service helping people figure out their taxes. It is estimated that taxpayers spend $150 billion to figure out their taxes, either hiring third parties or in time taken away from other activities. $150 billion that people are spending to figure out their taxes. That is amazingly high.

Do you have any sense of how that compares to other countries in the developed world?

Mr. SHULMAN. I do not, Senator.

Senator BROWNBACK. You have now got a growing set of countries that have moved to a flat tax. I think there is something like 16 that have gone to that system. I think it would be an interesting question to look at, what those countries spend in tax preparation time and money versus other places.

STIMULUS PAYMENTS

Are you going to have any difficulty getting the economic stimulus checks out on time?

Mr. SHULMAN. Since I have started the job, obviously this is something I am very focused on. Three times a week I have been in meetings with our staff. Everything looks like it is on track to have direct deposit checks go out the first week in May—start going out—and paper checks start going out shortly thereafter. So from everything I know, being in here 4 weeks, things look like they are on track to get the stimulus payments out on time.

Senator BROWNBACK. And to hit the dates?

Mr. SHULMAN. Hit the targets that are on our web site that we have promised all along.

Senator BROWNBACK. You have said that you have spent a lot of time getting people signed up to file tax forms so they could get their stimulus check. Did you get a number of new registrants fil-

ing tax returns? I believe you had a special super Saturday, March 29, to do this?

Mr. SHULMAN. We did something I am quite proud of, and it was a great way to start my first Saturday on the job. I went out to a retired veterans home and worked with our team. And we had 700 sites around the country open that Saturday, staffed with about one-half IRS and one-half volunteers. That day we had over 50,000 come into that combined group of sites.

We are tracking very closely people who we think are only filing for stimulus payments. Yesterday we just got all the 2007 returns. We are still processing paper returns. Later this month, we are actually going to look at the number of returns, try to figure out who we think is eligible, who has not filed yet, and then do another round of outreach. Our plan is actually to enlist both the administration and Members of Congress, if we see States where it looks like a lot of people have not availed themselves of the stimulus payments. We are going to be doing outreach and we will try to bring you in, as well, as partners.

Senator BROWNBACK. I do not know if many Members of Congress want to be very closely associated with the IRS, but maybe if it is passing checks out, that would change it.

Do you have any idea of numbers of what you are talking about here? I see your activities, but do you have any idea on numbers?

Mr. SHULMAN. We do not. It is very hard to estimate how many people are eligible. We are going to have a much better sense at the end of this month, and I can assure you our team will work on it. I have been pushing on this, and we are going to, hopefully by the end of the month, have a real sense of how many have come in and how many we think might still be eligible, based on Social Security rolls and other sources, and go out to more people.

Senator BROWNBACK. Will you be publishing, putting those numbers forth publicly?

Mr. SHULMAN. We would be happy to share them with you.

Senator BROWNBACK. I think it would be good just because we are all very concerned about the economy, how many people are going to get checks, or an estimate?

Mr. SHULMAN. Well, I am sorry. I might have misspoken. I was talking about the people who normally do not file who are eligible. We do have estimates of the broad numbers. We anticipate sending out over $100 billion in stimulus payments this year to over 130 million taxpayers. That is the gross number. We have not pinpointed the people who may be eligible who otherwise would not file a tax return, which is a group that we are very focused on providing service to.

Senator BROWNBACK. My time is up, but that is the number I was asking for, the number of people that you think would qualify but are not in the system getting or are not signed up, in your estimation who that would be? I would like to see if we could get that number.

Mr. SHULMAN. Absolutely.

Senator DURBIN. Senator Allard.

CONSERVATION EASEMENTS

Senator ALLARD. Thank you, Mr. Chairman.

I want to pursue my opening comments on the conservation easements of Colorado. It is my understanding in mid-November, the Internal Revenue Service began making settlement offers to a significant number of conservation easement donors under audit in Colorado. According to your agency, the settlements were only offered in those cases where the sole issue between the owner and the Internal Revenue Service was the valuation. The offers generally fell into a bucket where the IRS stated only 30 percent or 60 percent or 75 percent of the original value of the charitable donation was allowed.

And the question I have is, what were the criteria that you used to place different taxpayers into these various buckets, and did the IRS indicate in writing to the donor how and why you arrived at your decision, and if not, why?

Mr. SHULMAN. Senator, I understand this issue. I had the opportunity to speak with your colleague from Colorado, Senator Salazar, at length about this issue. And what I shared with him I will share with you. I have also done some research on this, knowing that this would be of issue to you.

My belief is that our job is to implement the tax laws in a way that achieves the intent of the policy that Congress puts forward, and so I share your goal that you talked about. The goal for quality of life and open space in Colorado is what we should be pursuing, which means we should make sure that we do not unduly restrict people trying to do the right thing and donate open space.

I have been briefed on this issue, and I will tell you what I know. And I would like to come back with Steve Miller for anything I do not know, and meet with you and continue to pursue this.

Since last fall, there has been some good progress, and 170 offers have been made. The numbers I was given were higher than the ones you just discussed, and so I have to dig into it more. But I understand that, in general, these 170 offers across the board—the general number was in the 70 percent range of the tax deduction that people had looked for. So it was a little higher.

Senator ALLARD. I just want to clarify for the record. You determined that it was overvalued by 70 percent. Is that what you said?

Mr. SHULMAN. No, that people were offered 70 percent of their original claim. So if they claimed $100, they were——

Senator ALLARD. You said, well, we will give you $70.

Mr. SHULMAN. $70—and that is in aggregate of these offers—is the number as I understand.

Senator ALLARD. Got you.

Mr. SHULMAN. I also know that you requested that we be liberal in granting extensions of time for people to analyze offers and come back, and the Service was responsive to that.

And I have been told that 20 to 25 more offers will go out in the next several weeks.

These offers were the valuation cases. There are a number of much more complex cases that were put behind the valuation cases to move forward. They are very fact-intensive. We are coordinating with the State of Colorado on all of those. So there is some time around coordination and these will take some more time.

Let me also tell you that the people running this program have told me they understand the frustration that you have around the

length of time this has taken, and that they are not happy with the pace and would like to pick up the pace. They actually asked me for some more resources for appraisers, and it is something that I authorized today to try to move this backlog through. As I said, I believe we need to be thorough, but we also need to be expeditious, so people can get on with their business.

Regarding the exact criteria, I have talked to the team about the program. I have not talked about any specific cases. I am 4 weeks into the job. I would like to request, if I could, to come back and talk with you.

What I will tell you is I believe we need to move the backlog. I have requested and authorized to put some more appraisers onto these cases, and I will be focused on it. I have told your colleague Senator Salazar that as well.

Senator ALLARD. Well, we are interested in seeing—you certainly have general criteria that you come to in doing your appraisals, and we would like to look at the qualifications of your appraiser on land values in Colorado particularly and have a concern about where maybe the Colorado Department of Revenue has already done a lot of the investigation, I hope you are not duplicating what they do. Maybe you can just assume that they have done a pretty good job and you follow with that and maybe save some time and expedite some of these jobs. And if you feel like you cannot, I would like to know why you feel like the State of Colorado is not doing an adequate job, and you need to go ahead and do that.

So I have a list of questions here, and my time is expired here. So we would like to get those to you and then you can review them and get back and give us some detail on where we are on getting this process moving forward in Colorado. Thank you.

Mr. SHULMAN. Thank you.

Senator ALLARD. Thank you, Mr. Chairman.

MISCLASSIFICATION OF WORKERS

Senator DURBIN. Thanks, Senator Allard.

Commissioner Shulman, this may have been done before you arrived, but the IRS prepared 16 legislative proposals and several administrative proposals for closing the tax gap with their 2009 budget submission. The one that is missing is a pretty big one. It is the misclassification of workers. It accounts for $148 billion in lost taxes each year. It represents 43 percent of the gross tax gap that we face as a country. It relates to people who call themselves independent contractors and evade payment of taxes that they are duly owing to the Federal and State government.

So I would like to ask you if you are familiar with this issue, if you know of any initiatives underway, if you can explain why it was not included as one of the proposals to close the tax gap.

Mr. SHULMAN. I was not here when that tax gap proposal, the general one, was put together, although I have studied it and I support moving forward with those proposals. I was also asked a lot about the tax gap during my confirmation hearing with the Senate Finance Committee. And I have made a commitment to take a fresh look at the tax gap and at least engage in a dialogue. And some of the tax gap issues have political consequences, as well as administrative consequences, which are going to be beyond the

IRS's purview, but my promise is to study it, come to my conclusions, and at least engage in that dialogue.

I do not want to answer your question wrong. I mean, my focus, and what I believe, is that a huge part of the tax gap is small business, pass-through business, and self-employed. And I have looked at that issue and am a big supporter of at least having the dialogue around information reporting and other issues around there. All of the studies I have done around the tax gap show that where there is withholding, there are the highest levels of compliance. Where there is information reporting, so people know that someone else is reporting information about them, there is the next highest level, and where there is no reporting and it is just on the honor system, there is a lower level of compliance, although a lot of people—most Americans—want to pay their fair share, and do pay their fair share, in taxes.

So I think that is what you are referring to. If not, I apologize for not being responsive.

Senator DURBIN. That is, and I will certainly give you time to take a look at that. A little more time.

Senator Brownback.

STIMULUS PAYMENTS

Senator BROWNBACK. Yes. On the next panel, one of the testimonies will be from the National Taxpayer Advocate, Nina Olson. I was just looking at her testimony. They were saying that you are planning on tax rebate checks to the 130 million taxpayers who file income tax returns, but also you must identify and process returns from and payments to more than 20.5 million people who have no filing requirement, yet are qualified for a tax rebate. That was just the number that has come out of this testimony. And if that is the case, that is a big number you are going to need to hit in pretty short order.

Mr. SHULMAN. Yes. That number—let me speak to that. I was hesitant to throw that one out because that was the gross estimate early on in the process. That does not take into account potentially eligible people on Social Security who are married, but who are not both eligible. So that number would be drawn down. It does not take into account dependents or people who are claimed as dependents on other forms. So I think that was the early gross estimate. We are going to have a much better sense once we get the filed numbers in.

Let me also just tell you, there are a variety of reasons—when I was out at the retired veterans home, there are a lot of people who are not part of the system and have not filed a return and might not want to file a return.

Senator BROWNBACK. They are not interested in being part of the system. I understand that.

Mr. SHULMAN. Yes, to get their $300 check.

So we are very focused on doing everything the IRS can do. I understood your comment about maybe not wanting to go out with us and publicize this, but we are going to try to be creative, once we see these numbers, about enlisting as many people as we can to get the word out.

Senator BROWNBACK. It is just that everybody is concerned about the economy. This was a big bipartisan push by the Congress and the administration to get this done. So we want as broad a reach as possible, and 20 million is a large number of people. But also I understand what you are saying about not everybody wanting to be in the system. Still, getting all those checks out is going to take a lot of work and you are on a short tether to get it done in the time period you are talking about.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Mr. Commissioner. I appreciate it very much.

And we are now going to invite panel number 2 to be seated. The panel includes Mr. J. Russell George, Mr. Paul Cherecwich, and Ms. Nina Olson. They have submitted extensive written statements, and Senator Brownback and I would appreciate it if they would do their best to confine themselves to 5-minute statements. Any statement that goes beyond 5 minutes, they will be presumed guilty and subject to penalties and interest.

Mr. George, how would you like to start?

STATEMENT OF J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEPARTMENT OF THE TREASURY

Mr. GEORGE. Thank you, Chairman Durbin, Ranking Member Brownback. I appreciate the opportunity to testify on the Internal Revenue Service's fiscal year 2009 budget.

As you heard from the Commissioner, the IRS's proposed fiscal year budget requests approximately $11 billion in direct appropriations. This amount is approximately a 4.3 percent increase over its fiscal year 2008 budget. The 2009 budget request seeks an increase of $337 million for enforcement. Meanwhile, funding for taxpayer services remains virtually the same as the 2008 appropriation. Funding for the business systems modernization project is reduced by more than 16 percent.

The previous Commissioner of Internal Revenue frequently stated that taxpayer service plus enforcement equals compliance. The budget request provides a 7 percent increase for the IRS's enforcement activities. As you are well aware and noted earlier, our Nation has a tax gap estimated to be grossly about $345 billion per year. A vital component of the effort to reduce the amount requires the IRS to take steps to ensure that everyone who owes Federal taxes pays their debt.

The fiscal year 2009 budget request seeks nearly $361 million in program increases for IRS enforcement initiatives. This amount accounts for 77 percent of the agency's overall funding increase. Part of the enforcement initiative funding would allow the Service to hire just over 3,000 new enforcement and operation support employees. The IRS estimates that these new employees will help generate more than $2 billion in additional annual enforcement revenue by fiscal year 2011.

In addition to hiring new employees, IRS enforcement initiatives will focus on enhancing activities targeted at improving compliance. The budget request supports this by proposing funding to reduce the tax gap for large and small businesses, as well as the self-employed, increase compliance of domestic taxpayers with offshore

activity, and minimize revenue loss by increasing document matching efforts.

The initiatives also include increased support for research to better understand the reasons for taxpayer noncompliance and implementation of legislative proposals to improve compliance.

It is noteworthy that the 2009 budget request does not seek additional funding for any taxpayer service initiatives above the 2008 funding levels. This was of concern to the Treasury Inspector General for Tax Administration (TIGTA). As you know, at the request of this subcommittee and Congress as a whole, the IRS has expended considerable resources to develop the taxpayer assistance blueprint. Many of the blueprint's initiatives would provide IRS customers with services similar to those that they are accustomed to receiving from private financial organizations such as online access to their accounts.

The IRS must continue to determine the kinds of assistance taxpayers want and need to ensure that the blueprint strategy is effectively implemented to meet those demands. However, most of these initiatives were not funded in 2008 and would remain unfunded in fiscal year 2009.

A key component of any success the IRS would hope to achieve in providing better service, as well as increased enforcement, is its business systems modernization effort. The modernization program has been a long-term challenge for the IRS. The 2009 budget request cuts funding for projects that are at the heart of the IRS's efforts to replace its antiquated computer systems. The program is in its 10th year and has paid out approximately $2.5 billion for contractor services. In addition, the IRS has spent $265 million through fiscal year 2007 in internal IRS costs and plans to spend an additional $223 million on a program in fiscal year 2008.

According to the IRS's original plan, the modernization program should have been past the halfway point this year. Although the IRS has made advances in the effort, it has not progressed as anticipated. While the IRS has improved its project management and contract oversight, the program remains behind schedule, over budget, and is not delivering what was promised.

For example, the IRS originally planned to complete the replacement of its individual master file with the customer accounts data engine in 2005. The current estimated completion date for this replacement is the year 2012.

In January 2005, the Government Accountability Office designated business systems modernization as a high-risk area. One reason for that designation is that the IRS's new systems need to include adequate audit trails to capture improper intrusions and unauthorized transactions.

Consistent with recommendations made by TIGTA in the past, the IRS has narrowed its efforts and is focused on three of its most important projects: the customer accounts data engine, the accounts management services, and the modernized e-file program. At this time, TIGTA does not know what impact the cuts on the modernization budget may have on these programs. The IRS declined to provide TIGTA with that information.

The final issue I will discuss—I beg your indulgence, Mr. Chairman—is the impending retirement wave. Thirty percent of the

IRS's current employees will be eligible to retire within the next 2 years, while nearly 40 percent of its executives are currently eligible to retire. GAO has designated human capital as a high-risk Government-wide concern. TIGTA has also designated the strategic management of human capital as one of the IRS's major management challenges. The loss of institutional knowledge places several of the IRS's critical projects at great risk, including the multiyear, multi-billion dollar effort to modernize its technology and related business processes.

It is vital that the IRS effectively implement the human capital strategies listed in its fiscal year 2009 budget request. Not only will the IRS need to place significant focus on recruiting, it will need to ensure that the new employees reach their full potential. At the same time, the IRS will need to retain its more experienced employees and capture the knowledge of those who leave the IRS.

Mr. Chairman, Ranking Member Brownback, thank you for your indulgence. I hope my discussion will help you in your deliberations.

Senator DURBIN. Thank you, Mr. George.

[The statement follows:]

PREPARED STATEMENT OF THE HONORABLE J. RUSSELL GEORGE

Chairman Durbin, Ranking Member Brownback, and Members of the subcommittee, thank you for the opportunity to testify today. My comments will focus on the Internal Revenue Service's (IRS) fiscal year 2009 budget and, at your request, the Treasury Inspector General for Tax Administration's (TIGTA) fiscal year 2009 budget request. I will also briefly comment on the status of the 2008 Filing Season.

The IRS administers America's tax laws and collects approximately 95 percent of the revenues that fund the Federal Government. The IRS has four major components: the Wage and Investment Division, the Small Business/Self-Employed Division, the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division. Together, these divisions are largely responsible for collecting more than $2 trillion in tax revenues each year. At a time when our Nation is at war, it is imperative to identify the resources required to support the IRS's role as steward of the country's tax administration system.

The IRS must continue to address management and operational issues, including modernization of its computer systems, addressing the tax gap, protecting taxpayer rights, and ensuring the security of its resources. To that end, the IRS has requested $11.4 billion to fund the agency's operations for fiscal year 2009. This is a 4.3 percent increase over the 2008 enacted budget. The IRS's fiscal year 2009 budget request for systems modernization is $40 million less than the fiscal year 2008 enacted amount. The IRS does not specify which programs will absorb these costs, only that the requested amount will allow continued progress on key modernization projects. However, millions of taxpayers entrust the IRS with sensitive financial and personal data stored and processed by its computer systems. The IRS faces enormous challenges in securing this vast amount of personally identifiable information, including ensuring that all systems have sufficient controls to prevent and detect intrusions and improper accesses.

The budget request includes a 7 percent increase for enforcement and less than a 1 percent increase for taxpayer service. In 2007 the IRS finalized strategies to reduce the tax gap and improve customer service.[1] The IRS is in the preliminary stages of both strategies. Determining what role taxpayer service plays in increasing voluntary compliance and reducing the tax gap will continue to be a challenge in the near future. The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and enforcement to promote voluntary compliance and reduce taxpayer burden.

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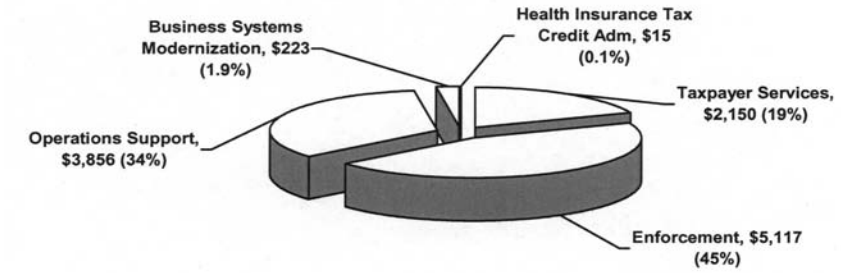
[1] *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (Washington, D.C.: Aug. 2, 2007); *The 2007 Taxpayer Assistance Blueprint Phase 2* (Washington, D.C.: 2007).

The proposed fiscal year 2009 IRS budget requests approximately $11.4 billion in direct appropriations, $107.9 million from reimbursable programs, and $177.7 million from user fees. The direct appropriation is approximately a $469.1 million increase (4.3 percent) over the fiscal year 2008 enacted level of $10.9 billion.

In fiscal year 2008, the IRS requested a budget of approximately $11.1 billion, an increase of $498 million (4.7 percent) over its fiscal year 2007 spending authority. The amount enacted by Congress for fiscal year 2008 was $203 million (1.8 percent) less than the budget request. Congress also made substantial changes in budget priorities in fiscal year 2008 by increasing the Taxpayer Services appropriation by $46.9 million above the IRS's request while cutting the Administration's Enforcement and Operations Support appropriation requests by a total of $235 million. The budget request also included a net increase in the overall size of the IRS of nearly 1,800 Full-Time Equivalent [2] employees.

The fiscal year 2009 IRS budget request includes appropriations for five IRS budget accounts (categories): Enforcement, Operations Support, Taxpayer Services, Business Systems Modernization, and the Health Insurance Tax Credit Administration (see Figure 1).

Figure 1: IRS Fiscal Year 2009 Budget Request (in millions)



Source: TIGTA analysis of Fiscal Year 2009 IRS Budget Request by IRS Budget Accounts.

Within these appropriation accounts, the IRS seeks to increase funding for Enforcement, Operations Support, and the Health Insurance Tax Credit Administration while decreasing funding for Business Systems Modernization (Modernization). The budget request seeks an Enforcement Appropriation of $5.12 billion, an increase of $337 million (7.1 percent) over the current fiscal year 2008 appropriation of $4.78 billion. The funding for Taxpayer Services remains the same as the fiscal year 2008 enacted level.

The Modernization program is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system.

The Modernization program is in its 10th year and has received approximately $2.5 billion for contractor services. Additionally, the IRS had spent $265 million through fiscal year 2007 for internal IRS costs, and plans to spend an additional $223 million on the program in fiscal year 2008. According to the IRS's original plan, the Modernization program should be past the halfway point in Calendar Year 2008. However, the IRS has not completed as many Modernization projects as planned because it has received less funding than initially anticipated and has had difficulties in managing the scope and complexity of the work. For example, the Customer Account Data Engine (CADE) is the foundation of the Modernization program. The IRS originally planned to complete replacement of its Individual Master

[2] A Full-Time Equivalent is a measure of labor hours. One Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

File with the CADE in 2005.[3] The current estimated completion date for this replacement is 2012.

Although the IRS has made advances in its Modernization effort, it has not progressed as anticipated. TIGTA has reported that inconsistent compliance with project development controls has contributed to delays in project deliveries, increased development costs, and reduced capabilities.[4] Since fiscal year 2002, TIGTA's Modernization program annual assessments have cited the following four specific challenges the IRS needs to overcome to deliver a successful modernization effort:

—Implement planned improvements in key management processes and commit necessary resources to enable success;
—Manage the increasing complexity and risks of the Modernization program;
—Maintain the continuity and strategic direction with experienced leadership; and
—Ensure that contractor performance and accountability are effectively managed.

Accordingly, because solutions to the IRS's serious and intractable financial management problems largely depend upon the success of its Modernization efforts, in January 2005 the financial management risk was combined with the Modernization risk into the Business Systems Modernization high-risk area.[5] Modernization remains a high risk for the IRS. One reason is that all of its new systems need to include adequate audit trails.

For fiscal year 2008, the IRS requested funding of approximately $222.7 million for Modernization, a cut of 16.6 percent ($44.4 million from the $267.1 million enacted). This cut is expected to eliminate at least 25 employees. However, the fiscal year 2008 enacted amount was an increase of $54.4 million (25.6 percent) from the $212.7 million enacted for fiscal year 2007.

The fiscal year 2009 budget request does not specify which programs will absorb the cuts, although it states that the requested amount will allow continued progress on key modernization projects, including the CADE, Accounts Management Services (AMS), and Modernized e-File (MeF). However, the Government Accountability Office (GAO) recently issued a report that included proposed spending by major project.[6] Figure 2 shows the funding proposed for major Modernization projects in fiscal year 2009 compared to the amounts enacted for fiscal year 2008:

FIGURE 2.—BUSINESS SYSTEMS MODERNIZATION PROJECTS IN FISCAL YEAR 2009 IRS BUDGET REQUEST

[In millions of dollars]

Project	Fiscal year 2008 enacted	Fiscal year 2009 budget request	Change from fiscal year 2008 enacted
Customer Account Data Engine	58.5	58.8	0.3
Accounts Management Services	29.0	26.2	(2.8)
Modernized e-File	55.8	25.0	(30.8)
Core Infrastructure	39.2	32.0	(7.2)
Architecture, Integration, and Management	35.1	35.0	(0.1)
Management Reserve	4.3	2.3	(2.0)
Subtotal Capital Investments	221.9	179.3	(42.6)
Business Systems Modernization Labor	44.0	42.0	(2.0)
Subtotal Program Request	265.9	221.3	(44.6)
Maintaining Current Levels	1.2	1.4	0.2

[3] The Individual Master File is the IRS database that stores individual taxpayer account information.

[4] *Annual Assessment of the Business Systems Modernization Program* (Reference Number 2007–20–121, dated August 24, 2007).

[5] In January 2005, the Government Accountability Office (GAO) combined its two previous high-risk areas, IRS Business Systems Modernization and IRS Financial Management, into one Business Systems Modernization high-risk area. See U.S. Government Accountability Office, GAO–05–207, *High Risk Series: An Update* (2005).

[6] *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, (GAO 08–567, dated March 2008).

FIGURE 2.—BUSINESS SYSTEMS MODERNIZATION PROJECTS IN FISCAL YEAR 2009 IRS BUDGET REQUEST—Continued

[In millions of dollars]

Project	Fiscal year 2008 enacted	Fiscal year 2009 budget request	Change from fiscal year 2008 enacted
Total Business Systems Modernization Budget	267.1	222.7	(44.4)

Source: TIGTA analysis of GAO Report, Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season (GAO 08–567, dated March 2008).

TIGTA requested information from the IRS on the impact of the proposed funding on the projects above, which the IRS declined to provide. The IRS also declined to provide this information to GAO for its report.

Customer Account Data Engine

The IRS states that the CADE is the lynchpin modernization project to replace the antiquated master file. The master file currently requires 2 weeks to update taxpayer tax accounts. The CADE consists of current and planned databases and is designed to post information to taxpayers' accounts daily rather than weekly, which will facilitate faster refunds to taxpayers and provide IRS employees with more up-to-date and accurate account information.

The latest release of the CADE, Release 3.0, was originally developed to deliver 17 new functions and capabilities. The IRS divided Release 3.0 into two sub-releases. CADE Release 3.1 contained four major functions and was deployed between August and October 2007. CADE Release 3.2 included seven major functions and was delivered in February 2008. The major functions delivered include the capability of processing tax returns with a disaster area designator; processing tax returns claiming the Earned Income Tax Credit, Credit for Child and Dependent Care, and requests for Split Refunds; providing address change service requests; and validating tax balances. The remaining six functions will be determined for delivery in future releases of the CADE. These additional capabilities were expected to significantly increase the volume of returns posting to the CADE from the approximately 11.2 million returns posted during Calendar Year 2007. As of March 28, 2008, about 21.1 million tax returns had been posted to the CADE.

In 2009, the IRS plans to continue the development of the CADE in stages, and its fiscal year 2009 budget request includes $58.8 million for the project. TIGTA's review of CADE Release 2.1 found that tax return information was accepted and generally posted accurately to CADE accounts during the 2007 Filing Season.[7] However, several programming problems were affecting the accurate posting of Itemized Deductions, Adjusted Gross Income, and Taxable Income amounts. TIGTA reported this issue to the IRS, and it promptly corrected the programming. TIGTA is currently reviewing the accuracy of the expanded capabilities offered by the most current release of the CADE.[8]

Accounts Management Services Project

The IRS is continuing to modernize its databases to provide immediate access to account data, enable real-time transaction processing, and ensure daily account settlement to improve customer service and business results. The Accounts Management Services (AMS) project, initiated in May 2006, was chartered to address these needs. The project objective is to provide an integrated approach to view, access, update, and manage taxpayer accounts. This is accomplished by providing IRS employees with the tools to access information quickly and accurately in response to complex customer inquiries and to update taxpayer accounts on demand. The fiscal year 2009 budget request includes $26.2 million for the AMS project.

In March 2008, TIGTA determined that the AMS project team successfully implemented project management processes and activities, which included project justification, contract management, risk management, configuration management, performance management, and transition management.[9] The AMS project team successfully planned work schedules, identified and addressed potential risks to project development, and coordinated with appropriate staff to implement initial release capabilities. Although the AMS project team is on schedule to make the proposed proc-

[7] *The Customer Account Data Engine Release 2.1 Generally Posted Tax Return Information Accurately* (Reference Number 2007–40–131, dated August 10, 2007).

[8] Customer Account Data Engine Release 3, (Audit Number 2008–20–009).

[9] *The Account Management Services Project Is Meeting Its Development Goals* (Reference Number 2008–20–053, dated March 3, 2008).

essing capabilities available, its implementation is dependent on the IRS's Modernization and Information Technology Services organization's abilities to integrate these project capabilities into taxpayer account processing.

The IRS, however, does not collect all transactions and audit logs on its modernized systems, including CADE and AMS. Without audit logs, the IRS cannot conduct proper intrusion investigations and hold individuals accountable for unauthorized transactions and disclosures.

Modernized e-File

The MeF project provides a standard filing structure for all types of IRS tax returns and can meet performance and capacity needs with enhanced and up-to-date technologies, therefore providing greater appeal to external customers and stakeholders. The MeF project's goal is to replace the IRS's current tax return filing technology with a modernized, Internet-based electronic filing platform.

In fiscal year 2009, the IRS will continue development of Release 7, which was initiated in fiscal year 2008. Release 7 will roll out an additional 90 supporting schedules and forms that will expand the reach of MeF to 99 percent of the e-File population, or approximately 93.7 million filers. The IRS's fiscal year 2009 budget request includes $25 million for the MeF project.

Previous TIGTA audits of the MeF project found that the IRS's plans for processing additional tax forms using the MeF system were uncertain, including plans to schedule development of the U.S. Individual Income Tax Return (Form 1040) family. In addition, the IRS can improve its management of requirements development and testing activities to assure that the requirements expected and approved for deployment are the requirements that are actually deployed.[10]

Furthermore, TIGTA continues to be concerned that the IRS is developing its modernized systems and bringing them online without adequately contemplating the security implications.

Human Capital

The IRS, like many organizations, is concerned about an impending retirement wave, or brain drain. According to the IRS, 30 percent of its current employees will be eligible to retire by 2010 and nearly 40 percent of its executives are currently eligible to retire. The GAO has designated human capital as a "high risk" Government-wide concern and recently reported that ample opportunities exist for agencies to improve. TIGTA has also designated the strategic management of human capital as one of the IRS's major management challenges.

Due to the potential loss of institutional knowledge, the IRS has several critical projects underway, such as a 5-year strategic plan for enhancing the services it provides to taxpayers and a complex, multiyear, multibillion dollar effort to modernize its technology and related business processes. The IRS is also battling a tax gap,[11] as well as implementing and adjusting to changes in its managerial and executive pay structure.

It is critical that the IRS effectively implement the human capital strategies listed in the IRS's fiscal year 2009 budget request. While acting to replace those employees lost through retirement and other attrition, the fiscal year 2009 budget request seeks more than 3,000 additional Full-Time Equivalents. The IRS states that additional employees will lead to increased revenue of more than $2 billion by the time new employees reach their full potential in fiscal year 2011. Not only will the IRS need to place a significant focus on recruiting, it will need to ensure that new employees reach their full potential. At this same time, the IRS will need to retain its more experienced employees and capture the knowledge of those who leave the IRS.

If the IRS is not able to effectively accomplish the human capital strategies:

—There might not be a sufficient number of qualified employees to adequately administer the tax code. In addition, fewer qualified employees may be on the front-line to assist taxpayers.

—The tax gap could increase if high-performing, well-trained taxpayer service and enforcement personnel cannot be hired and retained.

—The IRS might not be able to replace its leadership cadre and ensure that significant projects remain on track.

—The aging workforce could retire before its vast knowledge of tax administration is transferred to younger workers.

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[10] *The Modernized e-File Project Can Improve the Management of Expected Capabilities and Associated Costs* (Reference Number 2007–20–005, dated December 27, 2006); *The Modernized e-File Project Can Improve Its Management of Requirements* (Reference No. 2007–20–099, dated July 9, 2007).

[11] The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year.

TIGTA has an ongoing Human Capital audit strategy reviewing these areas and will continue to monitor the IRS's efforts to strategically plan and monitor human capital resources to ensure having the right resources in the right place at the right time to achieve its mission and goals.

SECURITY OF THE INTERNAL REVENUE SERVICE

Privacy and security are growing concerns in nearly every organization, both private and public. As technology advances, the IRS's ability to protect sensitive information must advance to meet new threats. In addition to the IRS's commitment to protect sensitive taxpayer data and personally identifiable information, a robust security program also requires adequate financial and human capital resources.

Each year, millions of taxpayers entrust the IRS with their sensitive financial and personal data that are stored in and processed by IRS computer systems. The risk that this sensitive data could be compromised and computer operations disrupted continues to increase. Both internal factors, such as the increased connectivity of computer systems and greater use of portable laptop computers, and external factors, such as the volatile threat environment related to increased phishing scams and hacker activity, contribute to these risks.

Network Security

Because the IRS sends sensitive taxpayer and administrative information across its networks, routers and switches on the networks must have sufficient security controls to deter and detect unauthorized use. In March 2008, TIGTA reported that access controls for IRS routers were not adequate and reviews to monitor security configuration changes were not conducted to identify inappropriate use.[12] Of 374 accounts for employees and contractors to access routers and switches in performing system administration duties, 141 (38 percent) did not have proper authorization to access the routers. Of particular concern, 27 employees and contractors had accessed the routers and switches to change security configurations.

To authenticate users, the IRS relies on a security application that requires users to enter an account name and password. Users circumvented this control by setting up unauthorized accounts that appeared to be shared-user accounts. Any person who knew the password to these accounts could have changed configurations without accountability and with little chance of detection. For this reason, the IRS requires that shared accounts be used only on a limited basis and that they be subjected to special authorization controls. However, during fiscal year 2007, 4.4 million (over 84 percent) of the 5.2 million accesses to the routers were made by the 34 user accounts. Audit trail reviews necessary to detect security events were also not being conducted. The IRS agreed with TIGTA's findings and is taking corrective actions to address the recommendations made to correct these weaknesses.

Database Security

The IRS stores its taxpayer, financial, and other data in more than 2,100 databases. TIGTA reported in fiscal year 2008 that high-risk weaknesses continue to exist and sufficient corrective actions have not been taken.[13] TIGTA scanned IRS networks and determined that 11 percent of the approximately 1,900 databases scanned had one or more installation accounts with a default or blank password. A total of 369 installation accounts had default or blank passwords, including 26 containing powerful database administrator privileges.

Databases found with default or blank passwords during the scans included those that contained personally identifiable tax information. Malicious users can exploit accounts with default or blank passwords to steal taxpayer identities and carry out fraud schemes.

TIGTA made several recommendations, including ensuring that security training is provided to employees with key security responsibilities and improving the process for identifying and correcting accounts with blank or default passwords by expanding the scanning criteria. IRS management agreed with all of the recommendations in the report and plans to take appropriate corrective actions.

IMPROVE TAXPAYER SERVICE

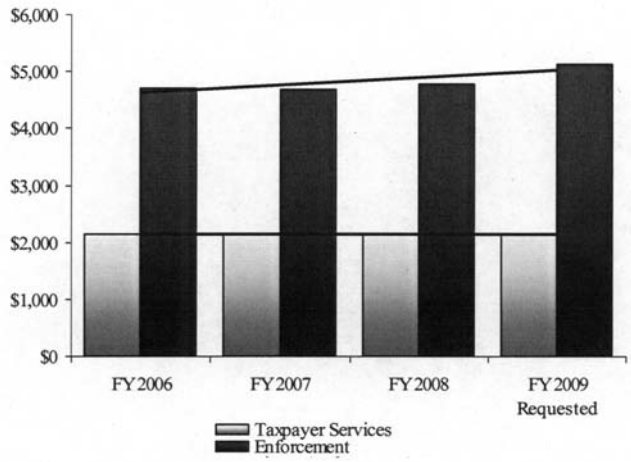
Since the late 1990s, the IRS has increased its delivery of quality customer service to taxpayers. The first goal in the IRS's current strategic plan is to improve taxpayer service. However, since the late 1990s, the IRS has allocated more resources

[12] *Inadequate Security Controls Over Routers and Switches Jeopardize Sensitive Taxpayer Information* (Reference Number 2008–20–071, March 26, 2008).

[13] *Internal Revenue Service Databases Continue to Be Susceptible to Penetration Attacks* (Report Reference Number 2008–20–029, dated December 14, 2007).

to its collection, examination, and criminal investigation functions and fewer resources to taxpayer service functions. See Figure 3 for a comparison of funding for taxpayer service and enforcement since fiscal year 2006.

Figure 3: Comparison of the Taxpayer Service and Enforcement Appropriations (in millions)



Source: TIGTA analysis of IRS budgets.

As a result of this resource shift and other factors, in July 2005, Congress requested that the IRS develop a 5-year plan, including an outline of which services the IRS should provide and how it will improve services for taxpayers. The IRS developed the plan, the Taxpayer Assistance Blueprint, in two phases.

The IRS is already facing challenges with its Blueprint. For the Phase I report, the conclusions and strategic improvement themes were valid; however, not all information was accurate or consistent.[14] Given the importance of this plan as the IRS moves forward, inaccuracies and inconsistencies will put the plan at risk of improperly aligning service content, delivery, and resources with taxpayer and partner expectations. In fiscal year 2007, the IRS issued its Taxpayer Assistance Blueprint Phase 2 report that details the research and analyses efforts of the IRS and outlines the Blueprint Strategic Plan for taxpayer services. The Phase 2 report contains information from over 100 data sources and represents the first large-scale effort to attempt to collect data specific to Taxpayer Assistance Center customers. In February 2008, TIGTA reported that the data in the Phase 2 report was for the most part accurate.[15]

A second review of the Phase 2 report focused on the Taxpayer Assistance Center[16] Geographic Footprint—the IRS's step-by-step process for future decisions regarding Taxpayer Assistance Center locations—and found that inaccurate and incomplete management information continues to delay its implementation.[17] The IRS has yet to determine the optimum locations for the Taxpayer Assistance Centers and which taxpayers they most effectively serve. Additionally, of the 41 criteria used

[14] *The Strategic Improvement Themes in the Taxpayer Assistance Blueprint Phase I Report Appear to Be Sound; However, There Were Some Inaccurate Data in the Report* (Reference Number 2007–40–078, dated March 18, 2007).

[15] *The Taxpayer Assistance Blueprint Phase 2 Was Generally Reliable, but Oversight of the Survey Design Needs Improvement* (Reference Number 2008–40–059, dated February 5, 2008).

[16] Taxpayer Assistance Centers are walk-in sites where taxpayers can receive answers to account and tax law questions, as well as assistance in preparing their tax returns.

[17] *Inaccurate and Incomplete Data Has Adversely Affected the Implementation of the Taxpayer Assistance Center Geographic Footprint* (Audit # 200740042), Draft issued March 20, 2008.

for the Taxpayer Assistance Center Geographic Blueprint, 19 (46 percent) contained inaccurate or incomplete data. Without accurate and complete data, the IRS cannot measure the effectiveness of the Taxpayer Assistance Center Program or determine where to best offer its face-to-face services.

The IRS is also still unable to measure how closing Taxpayer Assistance Centers might affect taxpayers and compliance. The IRS does not have the means to capture all interactions between a Taxpayer Assistance Center employee and a taxpayer to determine why the taxpayer visited the Taxpayer Assistance Center, what service he or she received, and, most importantly, the effect the service or action had on the taxpayer's future compliance.

The President' fiscal year 2009 budget request for the Taxpayer Service Program is $2.15 billion. The fiscal year 2009 funding for the direct appropriation maintains the fiscal year 2008 enacted level. The Operations Support budget provides an additional $1.5 billion to support taxpayer services.

—Fiscal year 2009 program decreases include funds provided in the fiscal year 2008 enacted. Specifically, $31 million is being used for long-term investments that would not be duplicated in 2009, and $8 million from the Community Volunteer Income Tax Assistance (VITA) Matching Grant Program that was provided in fiscal year 2008 and is still available through fiscal year 2009.

—Fiscal year 2009 increases include an additional 426 Full-Time Equivalents and $14.8 million to fully fund postal costs.

The budget request does not include funding to support any taxpayer service initiatives that increase its 2009 request over the 2008 enacted amount. The IRS has expended considerable resources to develop the Blueprint and many of its initiatives would provide its customers with the same services currently available to them from private financial organizations. Most of the Blueprint initiatives have not been funded. The IRS must continue to find out what assistance taxpayers want and need, and ensure that the Blueprint Strategy Plan is effectively implemented.

The IRS is implementing a new matching grant program for the Community VITA Grant Program with $8 million in fiscal year 2008 funding. The IRS's Volunteer Program, including the VITA and the Tax Counseling for the Elderly Programs,[18] plays an increasingly important role in the IRS's efforts to improve taxpayer service and facilitate participation in the tax system. TIGTA recently reviewed the Tax Counseling for the Elderly Program and found that it has not been effectively administered. The IRS does not have effective controls or monitoring processes to ensure that funds are appropriately spent, and management information is not sufficient to provide adequate oversight for the program. The IRS is using TIGTA's audit results to develop the VITA grant program.[19]

ENHANCE ENFORCEMENT OF TAX LAWS

A compelling challenge confronting the IRS is tax compliance. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax for businesses and individuals, and oversight of tax-exempt and Government entities. Late in fiscal year 2007, the Department of the Treasury and the IRS issued a report on improving voluntary compliance.[20] The report outlines steps that the IRS plans to take to increase voluntary compliance and reduce the tax gap.

The fiscal year 2009 IRS budget request seeks nearly $361 million in program increases for IRS enforcement initiatives, which account for 77 percent of the agency's overall funding increase of $469 million. Part of the enforcement initiative funding is intended to hire 3,057 new IRS Enforcement and Operations Support employees who are expected to help generate over $2 billion[21] in additional annual enforcement revenue, once the new hires reach full potential in fiscal year 2011. The $361 million increase is split between three appropriation accounts: Enforcement ($261 million), Operations Support ($97 million), and Taxpayer Services (nearly $3 million). Many of the same or similar enforcement proposals described in the fiscal year 2009 budget request were included in the fiscal year 2008 IRS budget request but not funded by Congress in the final appropriations bill, the Consolidated Appropria-

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[18] The Tax Counseling for the Elderly Program is a grant program that provides free tax help to people age 60 and older using grants appropriated. The Tax Counseling for the Elderly Program appropriation was $3.95 million for each of fiscal years 2005 through 2007 and $3 million in fiscal year 2008.

[19] *Oversight and Administration of the Tax Counseling for the Elderly Program Need Improvement*.

[20] Internal Revenue Service, U.S. Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (2007).

[21] Amount does not include annual $3.6 billion expected from legislative proposals.

tion Act of 2008.[22] The programs included in the enforcement initiatives in the fiscal year 2009 IRS budget request are shown in Figure 4:

FIGURE 4.—ENFORCEMENT INITIATIVE PROGRAMS IN FISCAL YEAR 2009 IRS BUDGET REQUEST

[Dollars in millions]

Program	Cost	Expected revenue fiscal year 2011	Staffing increase (full-time equivalents)	Included in fiscal year 2008 IRS budget request
Reduce the tax gap for small business/self-employed taxpayers.	$168.5	$981	1,608	Yes
Reduce the tax gap for large businesses	69.5	544	519	Yes
Improve tax gap estimates, measurement and detection of non-compliance.	51.1	16	393	Yes
Increase reporting compliance of U.S. taxpayers with offshore activity.	13.7	102	124	No
Expand document matching	35.1	359	413	Yes
Implement legislative proposals to improve compliance.	23.0	3,600		Yes
Totals	360.9	5,602	3,057	

Source: TIGTA analysis of fiscal year 2008 and fiscal year 2009 IRS Budget Requests.

ADDRESSING THE TAX GAP

Tax compliance initiatives include administering tax regulations, collecting the correct amount of tax for businesses and individuals, and overseeing tax-exempt and Government entities for compliance. Increasing voluntary compliance and reducing the tax gap are currently the focus of many IRS initiatives. Nevertheless, the IRS is facing significant challenges in obtaining more complete and timely data, and developing the methods necessary for interpreting the data. The IRS must continue to seek accurate measures for the various components of the tax gap and the effectiveness of the actions taken to reduce it. Broader strategies and better research are needed to determine what actions are most effective in addressing non-compliance.

Unreported Self-Employment Taxes Contribute to the Tax Gap

According to the GAO, outlays from the main trust funds of the Social Security and Medicare programs are projected to exceed revenues in the next decade. As the tax collector for these programs, the IRS must ensure that self-employed taxpayers meet their tax responsibilities by assessing and collecting the proper amount of self-employment taxes. Self-employment tax is estimated to make up about $39 billion (72 percent) of underreported employment taxes, or 11 percent of the total gross tax gap, making it one of the largest components of the tax gap.

TIGTA's fiscal year 2007 review of the self-employment tax found that IRS procedures were inconsistent for identifying Form 1040 reporting income on line 21 that is potentially subject to the self-employment tax.[23] Also, there was a significant problem with assigning an audit code to tax returns with potentially unreported self-employment taxes.

TIGTA recommended that the IRS: (1) improve processing of those tax returns with potential self-employment tax liabilities and provide additional training to tax examiners; (2) strengthen reviews of tax returns for potential unpaid self-employment taxes; and (3) reconsider the decision to cancel TIGTA's previous recommendation to immediately work significant unreported self-employment tax cases with refunds available and no response or an inadequate response to any letter issued by the IRS.

IRS management agreed with the first two recommendations and disagreed with the third. The IRS planned to explore the possibility of expanding existing returns processing training material issued in January 2008. However, IRS management stated that the parameters could not be accurately identified to ensure that the IRS would not be withholding the refunds of taxpayers who were not subject to self-employment taxes. Based on the findings of this and previous audits, TIGTA maintained that it was feasible for the IRS to begin examining the tax returns of tax-

[22] Consolidated Appropriation Act of 2008, Public Law 110–161.

[23] Identification of Unreported Self-Employment Taxes Can Be Improved (Reference Number 2008–30–001, dated October 11, 2007).

payers who appear to owe a significant amount of self-employment tax, have an available refund, and have not responded to contact letters from the IRS.

Schedule C Hobby Losses Contribute to the Tax Gap

About 1.5 million taxpayers, many with significant income from other sources, filed Form 1040 Schedules C (Profit or Loss From Business) showing no profits, only losses, over four Tax Years 2002–2005; 73 percent were assisted by tax practitioners. By claiming these losses to reduce their taxable incomes, about 1.2 million of the 1.5 million taxpayers potentially avoided paying $2.8 billion in taxes in Tax Year 2005. Changes are needed to prevent taxpayers from continually deducting losses in potential not-for-profit activities to reduce their tax liabilities.

The "hobby loss" provision and related regulations do not establish specific criteria for the IRS to use in determining whether a Schedule C loss is a legitimate business expense without conducting a full examination of an individual's books and records.[24] The purpose of the hobby loss provision was to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in "side-line" diversions to reduce their overall tax liabilities. TIGTA reported in September 2007 that 332,615 high-income taxpayers received the greatest benefit by potentially avoiding approximately $1.9 billion in taxes for tax year 2005.[25]

The law does not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer needs only the "objective" of making a profit. Internal Revenue Code (I.R.C.) §183 makes it difficult for the IRS to efficiently administer tax law that ensures taxpayers are not deducting not-for-profit losses to reduce their taxes on other incomes year after year.

TIGTA recommended that the IRS provide a copy of the report to the Department of the Treasury, Office of Tax Policy, to consider legislative changes to I.R.C. § 183. The proposal should include establishing a clearly defined standard or bright-line rule for determining whether an activity is a business or a not-for-profit activity. Due to the large number of these tax returns being prepared by tax practitioners, TIGTA also recommended that the IRS continue coordinating with practitioner organizations to encourage compliance with existing provisions.

In their response to the report, IRS officials stated that they agreed with the recommendations and planned to take appropriate corrective actions. The IRS plans to coordinate with the Office of Legislative Affairs to forward a copy of the final report to the Department of the Treasury, Office of Tax Policy, and to include key messages and talking points about I.R.C. §183 tax obligations as a fiscal year 2008 outreach initiative directed to practitioner organizations.

LEGISLATIVE PROPOSALS

The fiscal year 2009 IRS budget request includes 16 legislative proposals—13 submitted in prior budget requests—that are expected to generate $36 billion in additional tax over 10 years as a result of improving tax compliance and administration. Of the 13 proposals in prior budget requests, 12 await some form of congressional action. Many of these proposals also represent a significant part of the IRS strategy to improve tax compliance and reduce the tax gap described in the IRS's August 2, 2007, report, Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance.

2008 FILING SEASON

The 2008 Filing Season appears to be progressing without major problems. As of March 29, 2008, the IRS reported that it had received approximately 86.8 million tax returns. Of those, approximately 62.2 million were filed electronically (e-filed) (an increase of 9.3 percent from this time in 2007), and approximately 24.6 million were filed on paper (an increase of 4.8 percent from this time in 2007). Additionally, nearly 69.8 million refunds totaling approximately $172 billion had been issued. Of these, 50.8 million (73 percent of all refunds) were directly deposited to taxpayer bank accounts, an increase of 7.3 percent compared to 2007.

Use of the IRS's free online filing program had been declining in prior years. However, based on the current volume, it appears that taxpayers are increasingly taking advantage of this option, as the number has increased by 17.4 percent from 2007. Additionally, the number of taxpayers who e-file from their home computers increased by 17.3 percent this filing season.

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[24] Internal Revenue Code Section 183 (Activities not engaged in for profit); related Treasury Regulation Section 1.183–1.

[25] *Significant Challenges Exist in Determining Whether Taxpayers With Schedule C Losses Are Engaged in Tax Abuse (Reference Number 2007–30–173, dated September 7, 2007).*

So far this filing season, over 2 million tax returns have been prepared by volunteers, an increase of 22 percent over the 2007 Filing Season. TIGTA's accuracy rate at the Volunteer Program sites has improved from 56 percent last year to 67 percent this year. The IRS is reporting a 76 percent accuracy rate. Volunteers are doing a better job using the tools and information available when preparing tax returns.

As of March 29, 2008, use of IRS.gov is up over 19 percent, with almost 122 million visits to the Web site. Nearly 26 million taxpayers went to IRS.gov to obtain their refund information via the "Where's My Refund?" option, a 19.7 percent increase over the same time period last year.

Additionally, calls to the toll-free assistance lines are up from the 2007 Filing Season and the Level of Service[26] is lower, primarily because taxpayers are calling about the stimulus payments. The IRS had planned to provide an 82 percent Level of Service for fiscal year 2008, but has projected that the Level of Service could be as low as 74 percent. For the 2008 Filing Season (as of March 29, 2008), the IRS had already answered about 112 percent of the planned 10.9 million assistor-answered calls. Its 80 percent Level of Service is 4.5 points lower than the actual 2007 Filing Season Level of Service of 84.5 percent. Additionally, the IRS had planned to answer 14.8 million automated calls but has answered 16.1 million automated calls.

ECONOMIC STIMULUS ACT OF 2008[27]

In keeping with the intent of the Economic Stimulus Act of 2008, the IRS expects to issue more than $100 billion in stimulus payments (often referred to as rebates) and is trying to ensure that everyone who is entitled to a rebate knows what to do to receive it. The IRS sent Economic Stimulus Payment Notices (Notice 1377) to more than 130 million taxpayers who filed a Tax Year 2006 income tax return. Beginning in May, an additional notice will be mailed to those taxpayers eligible for the payments to explain the payment amount and how it was calculated. The IRS believes it will receive significantly fewer calls to its toll-free telephone information line as a result of issuing the advance notices.

As of March 28, 2008, the IRS had received an estimated 1.4 million tax returns from individuals who filed them solely to receive the rebates. Because these are tax returns that would generally not be filed, the normal IRS refund controls are not designed for this situation. The IRS is evaluating alternatives to identify any of these tax returns that are fraudulent so it can prevent any associated fraudulent stimulus payments. TIGTA is currently evaluating the controls over the processing of these tax returns and monitoring their volume and effect on the 2008 filing season.

Since the Economic Stimulus Act of 2008 was enacted, the IRS has been receiving an average of more than 63,000 calls per day above normal volume to its toll-free telephone lines related to the upcoming rebates. The IRS is using over 1,000 Automated Collection System[28] telephone assistors to take rebate telephone calls during their regular tours of duty and has also trained more than 500 tax examiners and assistors who normally work taxpayer correspondence and paper casework to answer general rebate calls.

The IRS stopped the issuance of Automated Collection System enforcement tools (systemic notices and letters were stopped on February 22 and systemic levies were stopped on February 29). However, issuance of regular delinquency notices on accounts not yet assigned to the Automated Collection System has not been stopped, and the IRS expects to reserve 40 percent to 50 percent of the available Automated Collection System staff to answer calls from taxpayers who respond to these notices. The IRS plans to restart the notices when telephone demand decreases. The IRS reports that the foregone revenue associated with these actions could be as high as $666 million.

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[26] The Level of Service is the primary measure of service to taxpayers. It is the relative success rate of taxpayers who call for services on the IRS toll-free telephone lines.

[27] Economic Stimulus Act of 2008, Pub. L. No. 110–185 (2008).

[28] The Automated Collection System is an integral part of the IRS process for collecting unpaid taxes and securing unfiled tax returns from both individual and business taxpayers. When taxpayers do not comply with the IRS's computer-generated notices, Automated Collection System tax examiners attempt to contact them by telephone to secure payments or unfiled returns. The Automated Collection System is the computer system that assigns these cases to the individual tax examiners.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION FISCAL YEAR 2009 BUDGET REQUEST

TIGTA was created by Congress to provide independent oversight of the IRS. TIGTA's audits and investigations protect and promote the fair administration of the Nation's tax system. Responsibilities include ensuring that the IRS is accountable for more than $2 trillion in tax revenue received each year. Audit recommendations aim to improve IRS's systems and operations while maintaining fair and equitable treatment of taxpayers. Investigations are focused on IRS employee misconduct and infrastructure security, as well as external attempts to corrupt Federal tax administration.

TIGTA's Office of Audit (OA) conducts audits that advise Congress, the Secretary of the Treasury, and IRS management of high-risk issues, problems, and deficiencies related to the administration of IRS programs and operations. Audits not only focus on the economy and efficiency of IRS functions but also ensure that taxpayers' rights are protected and the taxpaying public is adequately served. Overall, as of March 31, 2008, audit reports potentially produced financial accomplishments of $172.5 million, and potentially impacted approximately 1,217,000 taxpayer accounts in areas such as taxpayer burden, rights, and entitlements. OA develops an annual audit plan that communicates oversight priorities to Congress, the Department of the Treasury, and the IRS. Emphasis is placed on mandatory coverage imposed by the IRS Restructuring and Reform Act of 1998[29] and other statutory authorities, as well as issues impacting computer security, taxpayer rights and privacy, and financial-related audits. OA's work focuses on the IRS's major management challenges, the progress in achieving its strategic goals, the elimination of the IRS's systemic weaknesses, and the IRS's response to the President's Management Agenda initiatives.

TIGTA's Office of Investigations (OI) conducts investigations that protect the integrity of IRS employees, contractors, and other tax professionals; provides for infrastructure security; and protects from external attempts to threaten or corrupt the administration of Federal tax laws.

TIGTA's OI investigates employee misconduct involving unauthorized access (UNAX) of confidential taxpayer records, theft, false statements, financial fraud, taxpayer abuses, and extortion.

OI assists in maintaining IRS employee and infrastructure security by investigating incidents of threats or assaults made against IRS employees, facilities, and data infrastructure. As mentioned previously, the IRS's fiscal year 2009 budget request seeks a 7.1 percent increase in its enforcement appropriation. This continued focus on enforcement has resulted in OI receiving higher levels of reported assaults and threats against IRS personnel. Additionally, the IRS's increasing reliance on electronic processes has resulted in an increased need for OI to investigate and respond to cyber attacks.

TIGTA also investigates allegations involving external attempts to corrupt tax administration, such as bribes offered by taxpayers to compromise IRS employees, the use of fraudulent IRS documentation to commit crimes, taxpayer abuse and misconduct by tax practitioners, impersonation of IRS employees, and the corruption of IRS programs through procurement fraud.

TIGTA faces major human capital challenges in delivering and adapting its oversight activities to the increasingly complex and high-risk issues associated with IRS operations. Some of these issues include detection and investigation of fraud and electronic crime, procurement activities, taxpayer privacy, and an increasing number of requests for IRS program reviews from Congress and other IRS stakeholders. While adapting to this changing environment, approximately 37 percent of TIGTA employees are eligible for retirement by fiscal year 2011.

Additionally, in order to accomplish its mission, TIGTA employees need to possess the appropriate skills. As the IRS continues to modernize and operate in an automated environment, it is essential that TIGTA auditors and investigators are appropriately trained to operate in this environment.

To help address these challenges, TIGTA has initiated or is initiating the following actions in fiscal year 2008:

—Created the Office of Inspections and Evaluations whose mission is to provide TIGTA with additional flexibility, capacity and capability to provide value-added products and services to improve tax administration and promote good

[29] Pub. L. No. 105–206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

Government. This function was created and staffed by a realignment of existing resources.

—Implementing a bureau-wide electronic learning management system containing a skills assessment program that identifies the critical skills needed for each of TIGTA's major occupations and provides a means to assess resident skill levels. Based on the results, TIGTA will develop a strategic recruitment program to fill critical vacancies with the skills necessary to carry out its increasingly complex oversight activities and align future hiring in critical geographic areas.

—Building its first Senior Executive Service Candidate Development Program. The objective of the program is to promote a greater understanding of the mission and culture of the Federal Government and to train outstanding leaders and prepare them for the Senior Executive Service.

Mr. Chairman, as you requested, I will discuss TIGTA's 2009 budget needs. From fiscal year 2001 to fiscal year 2007, TIGTA's labor expenses have grown 20 percent from $88 million to $106.3 million, despite a substantial reduction in Full-Time Equivalents (a decrease of 16 percent from 938 to 792). Labor costs currently account for 80 percent of TIGTA's annual budget. As the number of TIGTA employees covered under the more expensive Federal Employees Retirement System increases, labor costs will continue to rise, reducing the funds available to TIGTA for non-labor spending.

Since fiscal year 2001, TIGTA has only been able to meet its financial obligations through Full-Time Equivalent losses and implementation of cost-cutting initiatives in non-labor expense categories. From fiscal year 2001 to fiscal year 2007, non-labor spending (such as training, travel, equipment, etc.) fell 9 percent from $19.5 million to $17.7 million. These costs currently consume 13 percent of TIGTA's annual budget.

The fiscal year 2009 President's budget request for TIGTA will be used to continue to provide critical audit and investigative services, ensuring the integrity of tax administration on behalf of the Nation's taxpayers. While there are a number of critical areas in which TIGTA will provide oversight, highlights of TIGTA's investigative and audit priorities include:

—Adapting to the IRS's continually evolving operations and mitigating intensified risks associated with modernization;

—Addressing the tax gap and enforcement efforts;

—Responding to threats and attacks against IRS employees, property, and sensitive information;

—Improving the integrity of IRS operations by detecting and deterring fraud, waste, abuse or misconduct by IRS employees;

—Conducting comprehensive audits, inspections, and evaluations that include recommendations for cost savings and enhancing the IRS's service to taxpayers; and

—Informing Congress and the Secretary of the Treasury of problems and progress made to resolve identified issues.

The total resources needed in fiscal year 2009 to support TIGTA's mission are $146,636,000, including $145,736,000 from direct appropriations and approximately $900,000 from reimbursable agreements. This is a $5.2 million (3.7 percent) increase over the fiscal year 2008 spending authority compared with the IRS's 4.3 percent increase.

I hope my discussion of the continuing challenges that face the IRS and TIGTA will assist you as you consider the fiscal year 2009 budget. Mr. Chairman and Members of the subcommittee, thank you for the opportunity to share my views.

Senator DURBIN. You should have filed for an extension 1 minute and 6 seconds ago.

Willie Nelson will be your hearing officer.

On behalf of the IRS Oversight Board, Paul Cherecwich.

STATEMENT OF PAUL CHERECWICH, JR., CHAIRMAN, INTERNAL REVENUE SERVICE OVERSIGHT BOARD

Mr. CHERECWICH. Chairman Durbin, Ranking Member Brownback, and members of the subcommittee staff who are here, thank you very much. My name is Paul Cherecwich. I am chair of the IRS Oversight Board.

One of our most important responsibilities is to ensure the IRS budget and related performance expectations support the IRS stra-

tegic plans. I would like to take this time to summarize the Board's recommendations for the IRS fiscal year 2009 budget.

If I had one word to characterize the difference between the Board's recommendations and the President's request, it would be "direction." I have taken the liberty of making a chart of one of the key figures in my written statement because I think that best illustrates the difference in the direction the Board is recommending.

This chart shows the four major line items in the IRS budget. The Board wants to spend more for service and information technology (IT) modernization. The President would spend less. It would appear that the Board and the President have similar recommendations for enforcement, but when you get inside the numbers, there are real differences in balance. And the Board would spend about $100 million more for infrastructure, but the President's budget would keep the infrastructure budget at its present underfunded state.

Let us start at the top with funding for taxpayer service. To put it simply, the Board wants the IRS to do more service, not less, especially service that helps taxpayers better understand their obligations and service targeted at underserved taxpayers. Most of the additional money for service that Congress added to the IRS budget last year would be eliminated by the President's budget. The Board believes the taxpayer assistance blueprint needs to be funded, and I have personally visited volunteers in tax assistance (VITA) sites in Utah, Georgia, and Kansas and can tell you that VITA is delivering important services to underserved taxpayers.

With respect to enforcement, it may seem that the Board and the President are making identical recommendations, for the funding is so close, about $360 million. And reality is my written statement shows the Board's recommended enforcement programs are spread more broadly and not focused exclusively in a few areas. As discussed in my statement, the Board has also questioned the ability of the IRS to absorb the requested staffing in its small business, self-employed, and large business divisions.

With respect to infrastructure, that is something that tends to be forgotten, but it is really quite important. The Board believes more funding for security is important in an age where the IRS is under increasing pressure to protect its databases from assault and keep taxpayer records private. I note that just the last week my colleague, Mr. George, issued a report chastising the IRS for their lack of security. The IRS does put a high priority on maintaining taxpayer privacy, but more should be done.

People are also an important part of the IRS infrastructure and more attention must be paid to having an aging workforce effectively pass along their skills and special expertise to the next wave of leaders and employees.

Now, the biggest difference in dollars between the Board and the President's budget is in business systems modernization (BSM). We have a $185 million difference between the Board's recommendation and the President's recommendation. By the way, this is the appropriations line. Technology modernization will result in major benefits to taxpayers and the Government. The Board believes the BSM to be the highest priority because of its ability to contribute to reducing the tax gap in the long term. We simply have to make

progress faster. TIGTA and GAO have recently been reporting positively on the business systems modernization program. This is not the time to go backward in funding.

Among other things, erratic funding makes program management more difficult and creates staffing issues for both the IRS and the contractors. When projects are cut back, you always lose the talented people you most want to keep.

Few taxpayers would use a financial institution that updated its accounts weekly. Yet, we accept that for the IRS. This has to change.

Modernized systems are required for electronic filing and financial controls. The failure of funding to upgrade the integrated financial system is going to prevent the IRS from managing its own accounts better.

Now that I have summarized the Board's recommendations on the four major accounts, let me make a point on the entire IRS budget. There is a television program on the Discovery channel called "Myth Busters" whose avowed mission is to separate truth from fiction, and I want to bust a myth about the IRS. The myth is that taxpayers who are also voters will be unhappy if too much money is appropriated for the IRS. The Board has tested that myth in our taxpayer attitude surveys and found it was wrong. My written statement provides the details.

PREPARED STATEMENT

In conclusion, the Congress must choose whether it wants to pursue short-term growth in enforcement activity over a more balanced path that stresses the benefits of long-term investments in technology infrastructure, service, and research.

Thank you for the opportunity to present the board's views.

Senator DURBIN. Thanks.

[The statement follows:]

PREPARED STATEMENT OF PAUL CHERECWICH, JR.

Chairman Durbin, Ranking Member Brownback, and members of the Subcommittee, thank you for this opportunity to present the Oversight Board's views on the administration's fiscal year 2009 IRS budget request. My name is Paul Cherecwich and I serve as Chairman of the IRS Oversight Board. My testimony explains the Board's recommendations for the IRS fiscal year 2009 budget and why the Board believes this level of funding is needed to meet the needs of the country and of taxpayers.

Created as part of the IRS Restructuring and Reform Act of 1998 (RRA 98), the Oversight Board's responsibilities include overseeing the IRS in its administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws. The Board is also responsible for ensuring that the IRS' organization and operations allow the agency to carry out its mission. To this end, the Board was given specific responsibilities for reviewing and approving annual budgets and strategic plans.

In fulfilling its responsibilities, the Board must ensure that the IRS' budget and the related performance expectations contained in the performance budget support the annual and long range plans of the IRS, support the IRS mission, are consistent with the IRS goals, objectives and strategies and ensure the proper alignment of IRS strategies and plans. In addition to my statement today, the Board developed a formal report in which it explains why it has recommended this budget for the IRS. I request that my statement and the report be entered into the committee record.

FISCAL YEAR 2009 IRS BUDGET RECOMMENDATIONS

One of the IRS Oversight Board's most important statutory responsibilities is to ensure that the IRS' budget request supports the agency's annual and long-term strategic plans. A budget request is more than a mechanism for appropriating funding; it's also a plan and a commitment. Not only does a proposed budget request funding, it also describes the activities the IRS will perform, how those activities align with the long-range strategic plan, and identifies measures to evaluate the expected results. A performance budget, properly used, enhances the ability of the IRS to meet its short-term performance targets and three strategic plan goals: (1) improve customer service; (2) enhance enforcement of the tax law; and (3) modernize the IRS through its people, processes and technology.

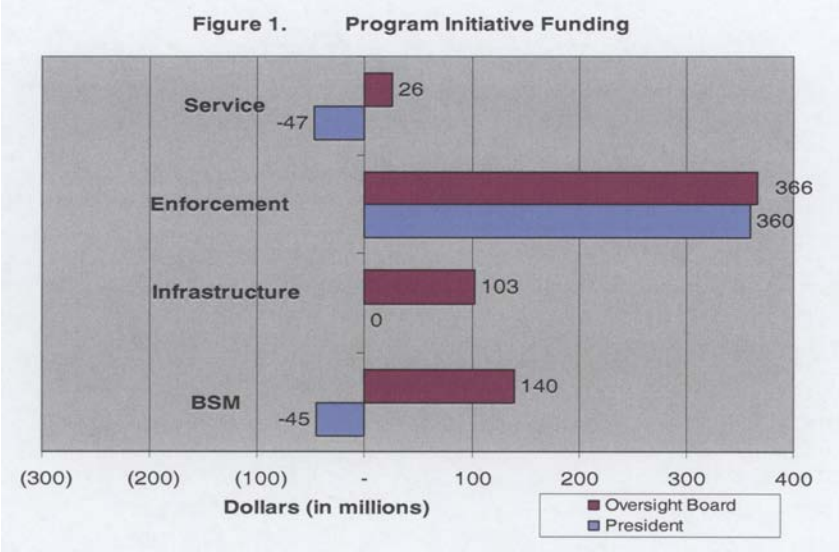
Achieving these three strategic goals will enable the IRS to address the most serious problem facing tax administration today—reducing the tax gap, the difference between what taxpayers should be paying and what they actually pay in a timely manner. The size of the tax gap is significant, with the IRS' most recent estimates placing it at approximately $290 billion (net) annually, based on 2001 tax returns. The imperative for closing the tax gap has never been greater. An annual net tax gap of $290 billion averages to about $2,200 per individual tax return, an enormous burden for the average taxpayer, and one that should not be tolerated by honest taxpayers. It is far too large to be dismissed lightly—it imposes a large burden on all taxpayers and undermines respect for tax administration.

The IRS Oversight Board recommends an IRS fiscal year 2009 budget of $11.737 billion, an increase of $845 million over the enacted fiscal year 2008 amount of $10.892 billion, as summarized in Tables A–1 and A–2 in Appendix A.

The recommended budget takes a long-term view of IRS needs. Despite the severity of the tax gap, the Board believes such a view is both warranted and needed. In submitting its fiscal year 2009 budget recommendations to the Treasury Department in June 2007, the Board identified increased funding for Business Systems Modernization (BSM), security, infrastructure, and research as high priorities. These initiatives offer the best opportunity to reduce the tax gap in the long term.

By following this approach, the Board's recommended budget maintains balance at its core: enforcement, taxpayer service, business systems modernization, and employee development must be adequately funded for the IRS to succeed in all parts of its mission and to ensure the long-term health of our tax administration system.

The Board's recommended IRS budget compares to the President's request of $11.361 billion, an increase of $469 million over the fiscal year 2008 enacted appropriation. Although the two budgets are within 3.3 percent, they take different approaches to funding priority program initiatives at the margin. The Board recommends a total of $644 million in program initiatives, spread among four areas: enforcement, taxpayer service, infrastructure and IT, and BSM. The President's budget requests a nearly identical amount of funding for enforcement initiatives as the Board, but cuts taxpayer service and BSM funds, and includes no program initiatives for infrastructure and IT. Figure 1 shows the differences in graphic form.



Although both budgets have as a core objective the reduction of the tax gap, the Board recommends funding initiatives across the full range of IRS functions and taxpayer segments. In contrast, the President's budget has as its central focus a short-term effort to build up IRS revenue-producing enforcement staffing at a time when the IRS is hard-pressed to replace the high number of experienced employees who are retiring. Increased staffing is important, but the Oversight Board believes the IRS cannot "audit its way out of the tax gap," and should avoid the temptation to close the tax gap with large staffing increases in revenue-producing functions that cannot be absorbed effectively. The Board believes its recommended budget avoids this problem by focusing on ways to make the IRS more efficient in the long term, and putting more resources into technology, infrastructure, and service as well as enforcement.

Because reducing the tax gap is of critical importance, the Board has identified a subset of its recommended initiatives as having the highest priority. These initiatives are generally infrastructure and research intensive and will have the greatest effect on reducing the tax gap in the long term, and are identified in Table 1.

TABLE 1.—IRS OVERSIGHT BOARD HIGHEST PRIORITY INITIATIVES

[Dollars in millions]

	Amount
Technology/Infrastructure:	
Fund Business Systems Modernization in Line with Current Strategy	$141.0
Enhance IT Security	$16.7
Enhance Contingency Planning and Disaster Recovery	$8.7
Implement Security Auditing	$6.8
Preserve quality IT workforce in applications development	$36.8
Build alternate power supply for computing center	$11.0
Subtotal, Technology/Infrastructure	$221.2
Enforcement: Improve tax gap estimates, measurement, and detection of non-compliance	$11.1
Taxpayer Service: Research Taxpayer Burden, Complexity, and Compliance	$10.0
Total Highest Priority Initiatives	$2.3

None of these initiatives, except the enforcement initiative for improving tax gap estimates, are funded in the President's budget. Moreover, as shown in Figure 1, the BSM program and taxpayer service programs undergo reductions of $45 million

and $47 million, respectively. The Board recommends that the appropriated IRS fiscal year 2009 budget closely follow the priorities and balance reflected in this statement.

The following sections discuss the Board's budget recommendations in the context of each of the IRS' strategic goals.

Strategic Goal 1—Improve Taxpayer Service

IRS customer service has made consistent gains since fiscal year 2002. For example, Toll-Free Tax Law Accuracy and Accounts Accuracy are at 91 percent and 93 percent respectively in fiscal year 2007, as compared to 84.4 percent and 90 percent 5 years ago. Of particular note, overall customer satisfaction with IRS Toll-Free Service has held steady at 94 percent for four consecutive years. Such stability is most welcome and a good indicator that best practices have taken root.

As a result, a more pressing challenge is to deliver more extensive electronic self-assistance tools and to perform research that identifies innovative ways to expand taxpayer education and outreach to all taxpayer segments, especially those who are now under served.

To a large degree, many of the IRS' customer service activities are designed to respond to taxpayer inquiries. Examples include toll-free telephone service and Taxpayer Assistance Centers. Overall, the IRS has done a good job fielding and answering questions, whether via toll-free telephone, the Internet, or in person at Taxpayer Assistance Centers.

The IRS expends considerably fewer resources on education and outreach services. A broader approach to customer service would entail giving taxpayers access to self-service applications so they could "pull" specific information on accounts or tax law, and "pushing" answers, information and updates to taxpayers, practitioners and other affected parties as the need for such information became apparent. Lastly, the IRS must seize opportunities to provide innovative outreach, education and community partnerships. For example, given limited resources and elimination of programs such as TeleFile, the IRS must also work to broaden and strengthen partnerships, such as Volunteers in Tax Assistance (VITA).

To take service to the next level, the IRS must better understand the taxpayers they serve. The IRS must conduct more insightful research, and develop services better tailored to the specific needs of particular taxpayer segments. By better understanding taxpayers, the IRS can focus both its service and enforcement efforts to increase compliance through targeted pre-filing, filing, and post-filing efforts. The IRS must find out what kind of information and assistance taxpayers need and the most effective ways of delivering that information to them.

In the last 2 years, the IRS has put considerable effort into developing the Taxpayer Assistance Blueprint (TAB), which establishes a 5-year plan for delivering service to taxpayers. This vision entails a much broader use of electronic interactions between taxpayers, practitioners and the IRS, such as account management and the ability to resolve taxpayer issues securely over the Internet. The TAB describes an IRS that is an "interactive and fully integrated, online tax administration Agency" with the capability "for any exchange or transaction that occurs face-to-face, over the phone, or in writing to be completed electronically." These types of services are much along the lines of what customers of large financial institutions already experience today but are still for the most part unavailable to taxpayers.

The Oversight Board disagrees with the President's program reductions for taxpayer service and recommends that the following three initiatives be funded for a total of $26.3 million:

—Maintain Processing of Critical Pension Plan Returns ($6.3 million);
—Research Taxpayer Burden, Complexity, and Compliance ($10 million); and
—Expand Volunteer Income Tax Assistance and Low Income Tax Clinics ($10 million).

The first initiative supports customer service by providing funds to maintain processing of essential pension plan return information while transitioning to a new mandated electronic filing system "EFAST2" in 2010. It also enables processing of residual returns that are IRS-only forms and not part of the mandated EFAST2 system (Form 5500EZ and Schedule SSA filings).

The second initiative provides funding to enhance understanding of the interaction between taxpayer burden, tax law complexity, and taxpayer compliance. This research will help improve understanding of these inter-relationships, in keeping with strategies put forth in the Taxpayer Assistance Blueprint (TAB) and the Department of the Treasury report, A Comprehensive Strategy for Reducing the Tax Gap.

The third initiative provides funding to improve service to two taxpayer segments with special needs: the growing number of elderly and the ethnically diverse. These

taxpayer segments face unique challenges in meeting their tax obligations because of limited access to or inability to use all of the channels offered for service delivery. Additional resources will enhance the IRS's volunteer return preparation and other services provided by the Volunteer Income Tax Assistance (VITA) and the Low Income Tax Clinic programs with emphasis on both targeted taxpayer segments. Such services help created a more fair and just tax system.

Strategic Goal 2—Enhance Enforcement of the Tax Law

Increases in IRS enforcement activity intended to produce gains in direct revenue collection must be balanced with a broad view of the tax gap. The Board recognizes that increased enforcement activity over the past five years has produced noticeable results—enforcement revenue has increased from $34.1 billion in fiscal year 2002 to $59.2 billion in fiscal year 2007, a gain of nearly 74 percent. The IRS estimates that it can produce more than a four-to-one return on every dollar invested in additional enforcement resources, a fact that the Board believes warrants the appropriation of additional enforcement funding.

However, while the Board applauds the increases in enforcement activity and revenue, it also recognizes that the IRS cannot "audit its way out" of the tax gap. There is wide belief, as evidenced by the Board's recommendations for reducing the tax gap and the Treasury Department's tax gap strategy, A Comprehensive Strategy for Reducing the Tax Gap, that an integrated set of comprehensive actions is needed. Even a large infusion of resources for more enforcement personnel—something highly unlikely—would not eliminate the tax gap. There are many reasons for taxpayer non-compliance. Only a balanced program that promotes voluntary compliance across a broad continuum of taxpayers, from education and service for those who want to comply, to enforcement and even criminal prosecutions for those who refuse to comply, can be effective.

Table 2 compares the Board's and President's enforcement initiatives. Although very close in dollars, the President's initiatives place more emphasis on enforcement resources that can be shown to produce revenue in the short term. The Board takes a broader view of enforcement, and recommends program increases in such areas as expanded collection of proper taxes from recipients of Federal payments, investigation of tax-related criminal activity, Bank Secrecy Act compliance, tax exempt organization examination, more published guidance for Tax Exempt taxpayers, additional litigation staff, and tax preparer monitoring.

Additional enforcement resources produce a positive return on investment and result in short-term benefits, so the benefits of increased enforcement are apparent. However, increases in enforcement resources must also be balanced with more systemic long-range actions that improve voluntary compliance, and priorities must be considered as budget resources are limited. The Oversight Board considers technology modernization and research a higher priority than additional enforcement resources, in recognition of the long-term impact that technology modernization and research have on the IRS' ability to work more efficiently to reduce the tax gap and to be better able to focus both its service and enforcement resources optimally.

TABLE 2.—COMPARISON OF ENFORCEMENT INITIATIVES FOR BOARD'S AND PRESIDENT'S BUDGETS

[Dollars in millions]

Oversight board's budget enforcement initiatives	Amount	President's budget enforcement initiatives	Amount
Reduce the Tax Gap for Small Business/Self-Employed	$120.7	Reduce the Tax Gap for Small Business/Self-Employed.	$168.50
Increase Reporting Compliance of Domestic Taxpayers with Offshore Activity.	16.4	Improve Reporting Compliance of U.S. Taxpayers with Offshore Activity.	13.70
Reduce the Tax Gap for Large Businesses	52.0	Reduce the Tax Gap for Large Business.	69.49
Expand Federal Payment Levy Program	17.3		
Reduce Tax Fraud	72.2		
Enhance Financial Investigations of Narcotics Trafficking Organizations.	24.0		
Enhance BSA Compliance Program	3.4		
Address Complexity through Up-Front Guidance, Education, and Correction.	8.9		
Expand Examination of Tax Exempt Organizations	28.6		
Increase Tax Court Litigation	5.8		
Implement New Procedural Tax Court Requirements	3.4		

TABLE 2.—COMPARISON OF ENFORCEMENT INITIATIVES FOR BOARD'S AND PRESIDENT'S BUDGETS—Continued

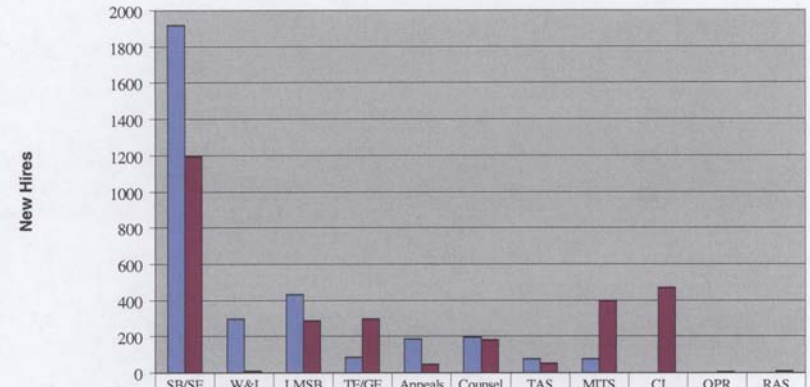
[Dollars in millions]

Oversight board's budget enforcement initiatives	Amount	President's budget enforcement initiatives	Amount
Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance.	11.1	.....	51.06
Increase Monitoring of Preparers	2.5	.....	.....
.....	.....	Expand Document Matching	35.06
.....	.....	Implement Legislative Proposals to Improve Compliance.	23.05
Total Enforcement	366.3	.....	360.85

Another factor that must be considered is the degree to which additional staffing can be absorbed into various IRS organizational units. Figure 2 depicts the distribution of new hires in major IRS organizations under the President's and Board's budgets. The Board believes its budget strikes a more balanced posture across all IRS organizational units and expands enforcement resources for a range of activities that are important elements of IRS enforcement, although they do not generate revenue directly, such as examination of tax exempt organization reporting, regulation of pension plans, and criminal investigation of tax fraud and abusive tax shelters. These activities are all part of a balanced, enforcement program that has as a goal the promotion of voluntary compliance among all taxpayer segments.

To better understand the impact of both budgets on the Small Business/Self-Employed (SB/SE) and Large and Mid-Sized Business (LMSB) organizations, the Board examined hiring requirements during fiscal year 2009 for both divisions. Table 3 shows the number of Mission Critical Occupation (MCO) employees projected to be on-rolls as of September 30, 2008, as well as the hiring requirements contained in both budgets. The Board has used a rule of thumb that 15 percent new hires is a reasonable limit on the amount of new employees that can be effectively accommodated into an organization in a year. It had concerns with the hiring implications of its own budget on SB/SE, but thought this risk could be mitigated. The President's budget would increase the percentage of new hires in SB/SE to over 23 percent of its employees in fiscal year 2009, and over 16 percent for LMSB.

Figure 2. New Hires by Organization; Board's vs. President's Budget



	SB/SE	W&I	LMSB	TE/GE	Appeals	Counsel	TAS	MITS	CI	OPR	RAS
President's budget	1918	295	433	87	187	199	79	77	0	0	0
Oversight Board budget	1192	10	286	298	48	180	55	399	468	3	10

TABLE 3.—SB/SE AND LMSB HIRING REQUIREMENTS IN THE BOARD'S AND PRESIDENT'S FISCAL YEAR 2009 BUDGETS

	Operating Unit Mission Critical Occupations			
	Oversight board budget		President's budget	
	SB/SE	LMSB	SB/SE	LMSB
Projected on rolls as of 9/30/2008	19,394	5,126	19,394	5,126
Projected Attrition Hires in fiscal year 2009	2,612	403	2,612	403
Projected New Hires in fiscal year 2009 to Meet Budget Request	1,177	273	1,918	433
Total Attrition Hires and New Hires	3,789	676	4,530	836
Percent of Hires to total MCO population	19.5	13.2	23.4	16.3

As in fiscal year 2006 through fiscal year 2008, the administration proposes to include its requested enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The Oversight Board's recommended enforcement initiatives would also qualify for such treatment, should Congress decide to make such an adjustment.

Strategic Goal 3—Modernize the IRS Through its People, Processes and Technology

The most effective strategy for reducing the tax gap in the long term is to provide the IRS with modern technology that enables it to operate at a high performance level. The Board has no doubts that a high performing organization with high service, quality, and satisfaction levels also minimizes taxpayer burden. Under such conditions, service and enforcement activities are prompt, efficient, and correct.

The Board has identified program initiatives for IT and infrastructure activities that are funded under the BSM and Operations Support accounts. These initiatives will further modernize the IRS core IT systems used for tax administration, upgrade its infrastructure, and improve its security posture.

BUSINESS SYSTEMS MODERNIZATION PROGRAM INITIATIVE

Tax administration is a knowledge-intensive activity and the IRS depends heavily on information technology (IT) to leverage the knowledge and perform its mission. The IRS has made slow but steady progress in replacing its antiquated IT systems. The most noticeable improvements to taxpayers have been increased use of electronic products and services to interact with the IRS. However, the IRS' performance is still hampered by archaic IT systems used for central record-keeping that update taxpayer account information on a weekly instead of a daily basis.

The Board has long advocated that the BSM program be funded at a higher level so progress could be made more quickly. Admittedly the program experienced a series of cost and schedule overruns during its first several years, and the result has been to slow down the funding stream to levels that dictate only modest progress can be made in modernizing the core IRS master files and account management systems. Because of its long-term effect on reducing the tax gap, the Board considers increasing BSM funding so that the pace of IT modernization can be increased as having the highest priority.

Figure 3 compares the BSM budget recommended by the Oversight Board, the amount requested by the President, and the BSM funding appropriated by Congress for fiscal years 2003 to 2008. BSM funding needs to be restored to the levels realized in fiscal year 2003 and fiscal year 2004 to make progress faster.

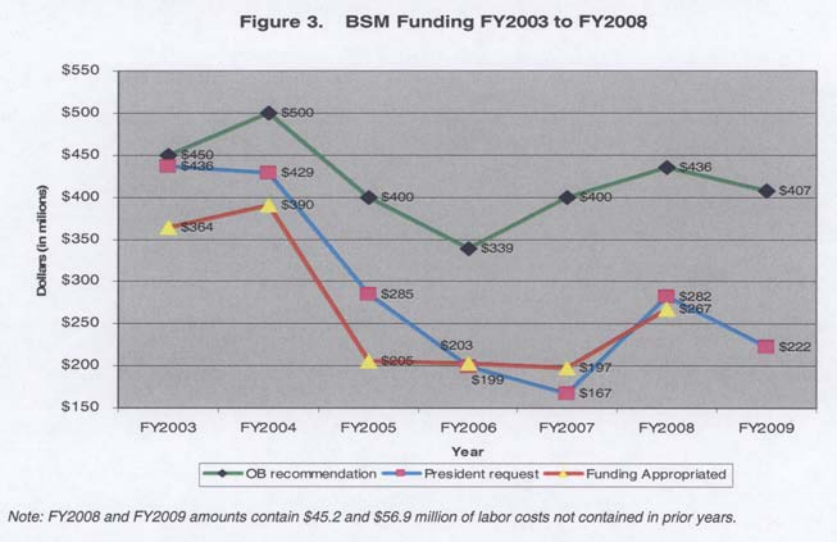


Table 4 shows the Board's and President's budgets for the BSM program in fiscal year 2009. Had the Board's funding recommendations been followed, the IRS would be closer to the day when it could update its central records on a daily basis.

TABLE 4.—APPLICATION OF FISCAL YEAR 2009 BSM FUNDING TO PROJECTS IN THE IRS OVERSIGHT BOARD'S AND PRESIDENT'S BUDGETS

[Dollars in millions]

Project activities	Fiscal year 2008	Oversight board		President	
		Fiscal year 2009	Increase over fiscal year 2008	Fiscal year 2009	Increase over fiscal year 2008
Customer Account Data Engine	58.5	80.0	21.5	58.8	0.3
Accounts Management Services	29.0	47.4	18.4	26.2	(2.8)
Modernized e-File	55.8	36.1	(19.7)	25.0	(30.8)
Common Services Project	.....	16.0	16.0	.....	.....
Integrated Financial System	.....	73.0	73.0	.....	.....
Core Infrastructure; Architecture Integration & Management; and Management Reserve	78.6	98.1	19.5	69.3	(9.3)
Subtotal Capital Investments	221.8	350.6	128.8	179.3	(42.6)
BSM Labor	45.2	56.7	11.5	43.4	(1.8)
BSM Program Total	267.1	407.3	140.2	222.7	(44.4)

Note: BSM program excludes $1.2 million of corporate costs in Operations Support.

The Board believes that when implemented, modernized IT systems will literally save taxpayers billions of dollars in burden reduction and make the IRS much more efficient. For example, replacement of the Individual Master File by the Customer Account Data Engine (CADE) will allow the IRS to update the tax accounts for individuals on a daily basis, instead of its current weekly update process. The Oversight Board expects that a rapid refund from the IRS of 3 to 5 days will reduce the number of Refund Anticipation Loans (RALs). The National Consumer Law Center and Consumer Federation of American estimate that approximately 12 million American taxpayers spent an unnecessary $1.6 billion on RALs in 2004 (the latest year for which data is available) to obtain their refund monies faster by 2 weeks. Moreover, daily updating of account records will give IRS employees and taxpayers access to the most current taxpayer account data, eliminating the problems associated with having various data bases with less than current status. The Oversight Board ex-

pects that daily posting of account information will improve the IRS' analysis capability and greatly reduce the burdens associated with the account resolution process.

The Modernized e-File system not only makes it easier for taxpayers to file tax returns with the IRS, it reduces the human resources needed to receive and process tax returns and eliminates the error-prone transcription process. For corporate filers, it helps the LMSB division improve currency and cycle time in working large corporate tax cases. When implemented for individual tax returns, it will make the electronic filing process even simpler than it is today with the current legacy electronic filing system.

The Integrated Financial System (IFS) will provide necessary improvements to the system the IRS uses to manage its financial resources, clearly a must for any agency, especially one that is responsible for managing taxpayers' accounts as well as its own appropriated resources. The IFS upgrade is needed to ensure that the IRS remains in compliance with Federal accounting and other financial management requirements. The additional funding for the IFS initiative will enable the IRS to add procurement and asset management modules to the existing IFS application and integrate related business processes with core accounting and financial management operations. The funding will also provide for the subsequent transfer of IFS to a Shared Service Center and thereby maintain its longer term viability.

The Board believes that funding for the BSM program should be accelerated, not slowed down. Failure to fund the IRS BSM program at higher levels, in the view of the Board, is a case of being penny-wise and pound foolish.

INFORMATION TECHNOLOGY/INFRASTRUCTURE PROGRAM INITIATIVES

The IRS must be held to the highest standards for security and data integrity while increasing its engagement in the electronic world in which most taxpayers already live. Meeting this dual challenge of high security and a high degree of electronic interaction with taxpayers demands that the IRS have a modern information systems and infrastructure.

The Board recommends six program initiatives for a total of $103 million that will improve the IRS' operations by allowing it to make critical improvements to its technology and personnel infrastructure. By comparison, the President's budget contains no initiatives for IRS infrastructure.

Three of the initiatives, totaling $32.2 million, enhance the IRS' security posture as the way the IRS does business continues to evolve and security threats seem to increase on a daily basis. Data security has taken on an expanded meaning in a post-9/11 world. Terrorists from around the globe are actively working to exploit weaknesses in Government IT security systems with the intent of producing both great physical and economic harm. Disrupting IRS returns processing and stealing sensitive information could wreak havoc on the economy and financial markets. The IRS cannot be complacent with respect to security, and the Board recommends the following security initiatives:

—Enhance IT Security ($16.7 million);

—Enhance Contingency Planning and Disaster Recovery ($8.7 million); and

—Implement Security Auditing ($6.8 million).

The first initiative enables the IRS to further implement key IT security and privacy safeguards to assure the integrity of sensitive taxpayer and employee data and supporting infrastructure processes. Protecting taxpayer data is paramount. The second initiative is to enhance the IRS enterprise-wide contingency planning and disaster recovery capabilities to support critical business systems. Any unavailability of critical IRS business systems poses an unacceptably high risk to the Nation's security. The third initiative, Security Auditing, will allow the IRS to more effectively monitor key networks and systems to identify any unauthorized activities.

The remaining three initiatives, for a total of $71.3 million, allow the IRS to improve other elements of its infrastructure. They are:

—Redesign Form 990 for Tax Exempt Organizations ($23.5 million);

—Preserve Quality IT Workforce in Applications Development ($36.8 million); and

—Build Alternate Power Supply for the Computing Centers ($11 million).

The first initiative, the only one that is not considered high priority, is recommended because it brings new efficiencies to tax filing for a segment of taxpayers who are frequently ignored because their tax returns do not produce revenue—tax exempt organizations. The Form 990 tax return is difficult to complete for tax exempt organizations to complete and for reviewers to comprehend. Worse, it fails to provide the IRS with sufficient information to detect and analyze compliance trends in the sector and target enforcement actions as needed.

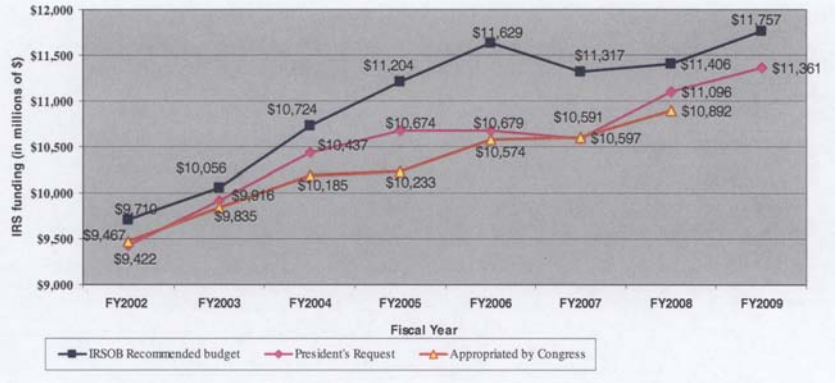
The second initiative will give the IRS better tools to retain its IT workforce by mitigating intellectual and experiential loss through a series of supporting strategies such as workforce re-tooling, succession planning, and retention. The third initiative provides alternate power supply for three of the IRS's computing centers. Currently there is but a single power supply facility at each of the computing centers. An alternate power supply capability at each of the three computing centers would ensure the continuous operation of, and continuous access to, tax processing systems at the computing centers during unplanned emergencies and planned power supply tests, and avoid the revenue loss and overtime expense associated with the current process that requires total shut down periods.

INVESTING IN IRS IS A GOOD BUSINESS DECISION SUPPORTED BY THE PUBLIC

In spite of recommendations made by the IRS Oversight Board, the IRS has not been funded at the most effective levels to achieve its strategic objectives. Figure 4 illustrates funding recommendations made by the Board since its inception, the President's budget request during this same time frame, and the funding appropriated by Congress. One of the principal reasons for this so-called "resource gap" is the budget process which treats the IRS the same as it does all other discretionary spending requests. It does not credit the IRS with bringing in 95 percent of all the revenue to fund the Federal Government, nor does it recognize the previously discussed four-to-one return on every dollar invested in tax enforcement.

The Oversight Board has urged previously Congress to view funding of the IRS as an investment.[1] Other members of the tax administration community, such as the National Taxpayer Advocate and the National Treasury Employees Union, have made similar recommendations.[2]

Figure 4. IRS Funding History FY2002-2009



There are a number of approaches that Congress could take to achieve this result, such as funding the IRS outside of budget caps, and the Board believes that the implementation of such a change is best left for Congress to decide. The Board would be remiss, however, if it didn't point out providing additional funds to the IRS has been consistently supported by nearly two out of three members of the public. In its annual Taxpayer Attitude Survey, the Board has asked taxpayers whether they support additional funding for the IRS. The results for 2005 through 2007 are shown in Table 5.

[1] IRS Oversight Board reports, *Fiscal Year 2006 IRS Budget Recommendations/Special Report, Fiscal Year 2007 IRS Budget Recommendations/Special Report, and Fiscal Year 2008 IRS Budget Recommendations/Special Report*.

[2] NTA, *2006 Report to Congress*, Section 2, p. 445, and Statement of Colleen M. Kelley, President, National Treasury Employees Union, Testimony Before the House Committee on Ways and Means, May 23, 2007.

TABLE 5.—RESULTS OF TAXPAYER ATTITUDE SURVEY ON IRS FUNDING

Survey question 11	Percent completely agree			Percent mostly agree		
	2007	2006	2005	2007	2006	2005
The IRS should receive extra funding to enforce tax laws and ensure taxpayers pay what they owe	24	24	20	40	39	43
The IRS should receive extra funding so it can assist more taxpayers over the phone and in person	21	24	22	42	42	44

The Board believes such strong support indicates the public understands the need for effective tax administration and realizes that, ultimately, it pays for itself.

CONCLUSION

Approving a budget is not just about money; it's also about choices. The Board believes its budget recommendations, if implemented, will put the IRS on an effective long-term path to achieving the IRS strategic goals, improving voluntary compliance, and reducing the tax gap.

Although the Board's recommended budget is $375 million more than the President's request, there are some important decisions that must be made with respect to priorities and balance. The Congress must not only decide the amounts to be appropriated, but must also choose whether it wants to pursue short-term growth in enforcement activity over a more balanced path that stresses the benefits of long-term investments in technology, infrastructure, service, and research.

APPENDIX A.—IRS OVERSIGHT BOARD RECOMMENDED IRS FISCAL YEAR 2009 BUDGET

TABLE A–1.—IRS OVERSIGHT BOARD'S RECOMMENDED FISCAL YEAR 2009 IRS BUDGET BY PROGRAM INITIATIVE

[In millions of dollars]

	Amount
Fiscal Year 2008 Enacted Appropriation	10,892.38
Base Adjustments	262.62
Savings/Reinvestments	(61.65)
Fiscal Year 2008 Base Budget	11,093.35
INITIATIVES	
Enforcement:	
Reduce the Tax Gap for Small Business/Self-Employed	120.7
Increase Reporting Compliance of Domestic Taxpayers with Offshore Activity	16.4
Reduce the Tax Gap for Large Businesses	52.0
Expand Federal Payment Levy Program	17.3
Reduce Tax Fraud	72.2
Enhance Financial Investigations of Narcotics Trafficking Organizations	24.0
Enhance BSA Compliance Program	3.4
Address Complexity through Up-Front Guidance, Education, and Correction Opportunities	8.9
Expand Examination of Tax Exempt Organizations	28.6
Increase Tax Court Litigation	5.8
Implement New Procedural Tax Court Requirements	3.4
Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance	11.1
Increase Monitoring of Preparers	2.5
Total Enforcement	366.3
Taxpayer Services:	
Maintain Processing of Critical Pension Plan Returns	6.3
Research Taxpayer Burden, Complexity, and Compliance	10.0
Expand Volunteer Income Tax Assistance and Low Income Tax Clinics	10.0
Total Service	26.3

TABLE A–1.—IRS OVERSIGHT BOARD'S RECOMMENDED FISCAL YEAR 2009 IRS BUDGET BY PROGRAM INITIATIVE—Continued

[In millions of dollars]

	Amount
Infrastructure/IT:	
Enhance IT Security	16.7
Enhance Contingency Planning and Disaster Recovery	8.7
Implement Security Auditing	6.8
Redesign Form 990 for Tax Exempt Organizations	23.5
Preserve Quality IT Workforce in Applications Development	36.8
Build Alternate Power Supply for the Computing Centers	11.0
Infrastructure/IT Initiatives Subtotal	103.5
Business Systems Modernization (BSM)	142.4
HITCA	5.50
Total Initiatives	644.00
Fiscal Year 2009 Budget Request	11,737.35
Fiscal Year 2009 Request Increase over Fiscal Year 2008 Base	844.97
Fiscal Year 2009 President's Request for IRS	11,361.51
Increase Over President's Budget Request	375.8

TABLE A–2.—IRS OVERSIGHT BOARD'S RECOMMENDED FISCAL YEAR 2009 IRS BUDGET BY APPROPRIATION ACCOUNT

[In millions of dollars]

	Taxpayer services	Enforcement	Ops support	BSM	HITCA	Total
Fiscal Year 2008 Enacted Appropriation	2,150.0	4,780.0	3,680.1	267.1	15.2	10,892.4
Base Adjustments	54.7	125.0	81.2	1.4	0.3	262.6
Savings/Reinvestments	(10.5)	(48.8)	(2.2)	.....	(0.2)	(61.6)
Fiscal Year 2009 Base Budget	2,194.2	4,856.2	3,759.0	268.4	15.4	11,093.4
INITIATIVES						
Enforcement:						
Reduce the Tax Gap for Small Business/Self-Employed	2.9	94.0	23.8	.....	.....	120.7
Increase Reporting Compliance of Domestic Taxpayers with Offshore Activity	.....	13.8	2.6	.....	.....	16.4
Reduce the Tax Gap for Large Businesses	.....	44.0	8.0	.....	.....	52.0
Expand Federal Payment Levy Program	0.4	16.5	0.4	.....	.....	17.3
Reduce Tax Fraud	.....	55.8	16.4	.....	.....	72.2
Enhance Financial Investigations of Narcotics Trafficking Organizations	.....	21.0	3.0	.....	.....	24.0
Enhance BSA Compliance Program	.....	2.8	0.6	.....	.....	3.5
Address Complexity through Up-Front Guidance, Education, and Correction Opportunities	1.1	6.5	1.3	.....	.....	8.9
Expand Examination of Tax Exempt Organizations	0.2	23.3	5.1	.....	.....	28.6
Increase Tax Court Litigation	.....	5.0	0.8	.....	.....	115.8
Implement New Procedural Tax Court Requirements	.....	2.8	0.5	.....	.....	3.4
Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance	.....	7.6	3.5	.....	.....	11.1
Increase Monitoring of Preparers	.....	2.2	0.4	.....	.....	2.5
Total Enforcement	4.7	295.2	66.5	.....	.....	366.3
Taxpayer Services:						
Maintain Processing of Critical Pension Plan Returns	6.0	.....	0.2	.....	.....	6.3
Research Taxpayer Burden, Complexity, and Compliance	.....	.....	10.0	.....	.....	10.0
Expand VITA and Low Income Tax Clinics	9.8	.....	0.2	.....	.....	10.0
Total Service	15.8	.....	10.5	.....	.....	26.3
Infrastructure/IT:						
Enhance IT Security	.....	.....	16.7	.....	.....	16.7

Enhance Contingency Planning and Disaster Recovery	.....	.....	8.7	.....	.....	8.7
Implement Security Auditing	.....	.....	6.9	.....	.....	6.9
Redesign Form 990 for Tax Exempt Organizations	.....	.....	23.5	.....	.....	23.5
Preserve Quality IT Workforce	.....	.....	36.8	.....	.....	36.8
Build Alternate Power Supply for the Comp Centers	.....	.....	11.0	.....	.....	11.0
Infrastructure/IT Initiatives Subtotal	.....	.....	103.5	.....	.....	103.5
Business Systems Modernization (BSM)	.....	.....	1.2	141.2	.....	142.4
HITCA	.....	.....	.....	.....	5.5	5.5
Total Initiatives	20.5	295.2	181.6	141.2	5.5	644.0
Fiscal Year 2009 Budget Recommendation	2,214.7	5,151.4	3,940.6	409.7	20.9	11,737.4
Fiscal Year 2009 Recommendation over Fiscal Year 2008 Enacted	64.7	371.4	260.6	142.6	5.7	845.0
Fiscal Year 2009 President's Request for IRS	2,150.0	5,117.3	3,856.2	222.7	15.4	11,361.5
Increase Over President's Budget Request	64.7	34.2	84.5	187.0	5.5	375.9

Senator DURBIN. Taxpayer Advocate, Nina Olson.

STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE

Ms. OLSON. Chairman Durbin, Ranking Member Brownback, and members of the subcommittee, thank you for inviting me to testify on the proposed budget of the IRS for fiscal year 2009.

As an initial matter, I want to acknowledge that the IRS is doing an excellent job with most of its core services as illustrated by its ability to pull off the recent filing season despite the late AMT patch and the need to apply its limited resources to providing stimulus payments. There are always tasks the IRS could perform better and I will address some of those today, but I think it is important to take a moment to reflect on the vast responsibilities the IRS must meet to collect the revenue our Government requires to function and to acknowledge how much the IRS does very well.

Now, I would like to emphasize five points.

First, in my 2006 annual report to Congress, I recommended that Congress provide the IRS with after-inflation budget increases of about 2 to 3 percent a year for the foreseeable future. Assuming the funds are wisely spent, I believe that each additional dollar appropriated for the IRS will generate substantially more than $1 in increased Federal revenue. Providing adequate funding for the IRS, which is in reality the accounts receivable department of the Federal Government, is a wise financial investment.

Second, one of the most critical choices facing tax administration is how to allocate resources between taxpayer services and tax law enforcement. While I believe that both categories would benefit from additional funding, I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer services. Over the 5-year period, fiscal year 2004 through fiscal year 2008, GAO concluded that funding for enforcement has increased substantially while funding for taxpayer services has been reduced. The budget proposal for fiscal year 2009 would continue this trend.

Moreover, while the taxpayer services appropriation is currently $2.2 billion, more than 70 percent of those funds are used for filing and account services, mostly the processing of tax returns. Return processing is not pure taxpayer service but also constitutes the first step in screening returns for audit. The budget subcategory titled "pre-filing taxpayer assistance and education" is what most people think of as core taxpayer service, and significantly, only 6 percent—6 percent—of the IRS budget, or $645 million, is currently devoted to this area. The budget proposal would reduce this $645 million taxpayer service amount by about $28 million, a reduction of 4.35 percent in nominal terms and a larger reduction after taking into account inflation.

There are no reliable data that show that more enforcement is more effective than more taxpayer service in increasing compliance. I believe the IRS can produce a positive return on investment from more funding in both areas, but given limited resources, I think it is misguided to continue to ramp up enforcement at the expense of providing core taxpayer services.

Third, research plays a vital role in helping the IRS make the major strategic and operational decisions needed to effectively ad-

minister the tax system. Just as research and development (R&D) is critical to a technology company as it seeks to improve the products and services it provides to customers, tax administration-related research is critical to the IRS as it seeks to meet taxpayer service needs and improve tax compliance in a cost effective manner. For that reason, I have consistently advocated for a more robust IRS research capability.

The Taxpayer Advocate Service has initiated or worked with the IRS to conduct taxpayer-centric research on several enforcement and service issues. Some of these projects have been undertaken in response to appropriations directives and they are detailed in my written statement.

In my annual reports to Congress and in prior testimony, I have expressed serious concerns about many aspects of the private debt collection initiative. I now add to these concerns the issue of foregone revenue. Very simply, the PDC initiative will cost the Government more than $81 million in foregone revenue this year, and the cost is likely to reach nearly $500 million over the next 6 years. Moreover, 46 percent of the fully paid liabilities included in PDC gross revenue have been collected through offsets or direct payments made by the taxpayer after receiving a letter from the IRS informing the taxpayer that his or her account would be placed with a private collection agency (PCA), but before the PCA made contact with the taxpayers. These fully paid liabilities are a direct result of IRS action, not action taken by the PCA. Although the purpose of the private debt collection (PDC) program is obviously to raise revenue, the PDC program has lost revenue in absolute terms and will continue to cost the Government significant foregone revenue each year.

I will make my fifth point in my written statement so I am not penalized.

Senator DURBIN. Thank you very much, Ms. Olson.

[The statement follows:]

PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman, Ranking Member Brownback, and distinguished Members of the Subcommittee: Thank you for inviting me to submit this written statement regarding the proposed budget of the Internal Revenue Service (IRS) for fiscal year 2009. I will address the overall level of funding I believe the IRS should receive, the allocation of that funding between enforcement and taxpayer service, and a number of important tax administration issues in which this Committee has expressed an interest. I approach these issues from my perspective as the National Taxpayer Advocate, the voice for taxpayers and taxpayer rights inside the IRS.[1]

As a threshold matter, I want to acknowledge that the IRS is doing an excellent job with most of its core services, and it is seriously attempting to improve its operations in other areas. This filing season alone demonstrates that when the IRS devotes its full attention to a task, it performs it extraordinarily well. As I noted in my 2007 Annual Report, late-year tax-law changes impact both taxpayers and the IRS, and the uncertainty surrounding such changes increases the risk that problems

[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

will arise with basic service delivery and return processing.[2] These challenges increase when the IRS must devote substantial resources during the filing season to a major new initiative, such as preparing to issue the recently authorized economic stimulus payments. To deliver these payments, the IRS not only must process payments to the over 130 million taxpayers who currently file income tax returns, but it also must identify and process returns from and payments to more than 20.5 million persons who have no filing requirement.[3] All of these exigencies divert the IRS from other important work, yet the fact that the IRS has managed to turn on a dime and deliver this filing season without significant glitches is a testament to the extraordinary people who work at the IRS.

There are always tasks the IRS could perform better—and I will address some of them below—but I think it is important to take a moment to reflect on the vast responsibilities the IRS must meet to collect the revenue our Government requires to function and to acknowledge how much the IRS does very well.

To Increase Federal Revenue, Congress Should Provide Increases in IRS Personnel Funding at a Rate of About Two Percent to Three Percent a Year Above Inflation

In my 2006 Annual Report to Congress, I recommended that Congress provide the IRS with after-inflation increases of about 2 percent to 3 percent a year for the foreseeable future. Assuming the funds are wisely spent, I said that I believe increasing the IRS budget at this rate is an excellent financial investment. I continue to believe this is the case.

Most Federal expenditure programs are just that—expenditure programs. The funds are intended to be spent on worthwhile programs, but the expenditures generally do not directly generate more Federal revenue.

The IRS is different. The IRS is effectively the Accounts Receivable Department of the Federal Government, and it collects about 96 percent of all Federal revenue.[4] On a budget of about $10.6 billion,[5] the IRS collected about $2.24 trillion in fiscal year 2006.[6] In other words, every $1 spent on the IRS produced about $210 in Federal revenue.[7]

If the Federal Government were a private company, its management clearly would fund the Accounts Receivable Department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not—in and of itself—an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if the IRS were given more resources, it could collect substantially more revenue.

In his final report to the IRS Oversight Board in 2002, former Commissioner Charles Rossotti presented a discussion titled "Winning the Battle but Losing the War" that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS

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[2] *See* National Taxpayer Advocate 2007 Annual Report to Congress 3–12 (Most Serious Problem: The Impact of Late-Year Tax-Law Changes on Taxpayers).

[3] Approximately 20.5 million persons received Social Security or Veterans benefits and are therefore likely to qualify for stimulus payments but did not file tax returns in 2006. IRS News Release, *Special Economic Stimulus Payment Packages Go to Social Security, Veterans Recipients*, IRS–2008–37 (Mar. 10, 2008). There is also an unknown number of low income taxpayers who ordinarily would not have a filing requirement but will have to file this year to receive stimulus payments.

[4] Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 84 (Nov. 2006).

[5] Department of the Treasury, *Fiscal Year 2007 Budget in Brief* at 59.

[6] Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected $2.51 trillion on a gross basis in fiscal year 2006, but issued $277 billion in tax refunds.

[7] When collecting tax from the vast majority of taxpayers who file returns and pay all or substantially all of the tax they owe voluntarily, the cost the IRS incurs per taxpayer is very low. As the IRS attempts to collect tax from noncompliant taxpayers through broader outreach efforts or through examination and collection actions, the cost per taxpayer rises substantially. Therefore, the *marginal* ROI the IRS achieves as it attempts to collect unpaid taxes is likely to be considerably lower than the *average* ROI of 210:1 that the IRS achieves on taxes paid voluntarily. But if the IRS were given more resources, most data indicate that the IRS could generate a substantially positive marginal ROI.

lacked the resources to handle cases worth about $29.9 billion each year. It placed the additional funding the agency would have needed to handle those cases at about $2.2 billion.[8]

Significantly, this estimate reflected only the potential direct revenue gains. Economists have estimated that the indirect effects of an examination on voluntary compliance provide further revenue gains. While the indirect revenue effects cannot be precisely quantified, two of the more prominent studies in the area suggest the indirect revenue gains are between 6 and 12 times the amount of a proposed adjustment.[9]

I want to emphasize that the existing modeling in this area is not especially accurate, and estimates of both the direct and indirect effects of IRS programs vary considerably. As I will discuss below, the IRS needs to develop better modeling to produce more accurate return-on-investment estimates. But I also want to emphasize that almost all studies show that, within reasonable limits, each additional dollar appropriated to the IRS should generate substantially more than an additional dollar in Federal revenue, assuming the funding is wisely spent.

The IRS Currently Spends Only Six Percent of Its Budget on Taxpayer Assistance and Education; a More Equitable Balance Between Taxpayer Services and Enforcement Should Be Achieved

One of the most critical choices facing tax administration is how to allocate resources between taxpayer services and tax-law enforcement. While I believe that both categories would benefit from additional funding—and I do not believe the categories should be viewed as mutually exclusive—I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer service.

After the administration issued its fiscal year 2008 budget proposal last year, the GAO analyzed recent IRS funding trends. Over the 5-year period fiscal year 2004 through fiscal year 2008, it concluded that funding for enforcement has increased substantially while funding for taxpayer services has been reduced. Based on the administration's proposal for fiscal year 2008, it pointed out that funding over the fiscal year 2004 through fiscal year 2008 period would increase by 19.4 percent for enforcement while funding for taxpayer services would decline by 3.8 percent.[10] The final appropriations bill for fiscal year 2008 made a modest adjustment to the administration's proposal, providing about $46.9 million more for taxpayer service and $145 million less for enforcement.[11]

However, the proposal for fiscal year 2009 would continue the trend of spending relatively more on enforcement. The pending budget proposal would increase enforcement spending by $490 million (7 percent), while increasing spending for taxpayer services by only $23 million (0.6 percent).[12] Thus, after inflation, the proposal would reduce taxpayer services spending still further.

Moreover, the budget categories of "Taxpayer Services" and "Enforcement" are misleading. Of the $2.2 billion in the "Taxpayer Services" category, only $645 million, or 6 percent of the IRS budget, is currently allocated for "Pre-filing Taxpayer Assistance and Education."[13] A significant majority of funds under the "Taxpayer Services" category is allocated for "Filing and Account Services," which largely covers the processing of tax returns. Returns processing is hardly a pure service activity. While it does enable the IRS to issue tax refunds, it is an internal processing function that also constitutes the first step in screening returns for audit. In any event, it is far removed from the type of taxpayer service that informs taxpayers about their tax obligations and assists them in complying with the laws. The budget proposal would reduce funding for taxpayer assistance and education from $645 mil-

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[8] Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 16 (Sept. 2002).

[9] Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 35–36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, The Effect of Audit Rates on the Federal Individual Income Tax, 1977–1986, 43 Nat. Tax J. 395, 396, 405 (1990).

[10] Government Accountability Office, GAO–07–673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 27 (April 2007). These numbers are apparently not adjusted for inflation. GAO reported that overall IRS funding would increase, on an inflation-adjusted basis, by a mere 0.5 percent from fiscal year 2004 to fiscal year 2008 under the Administration's proposal. *Id.* at 26.

[11] *Compare* Department of the Treasury, *Fiscal Year 2009 Budget in Brief* at 53 *with* Department of the Treasury, *Fiscal Year 2008 Budget in Brief* at 55.

[12] Department of the Treasury, *Fiscal Year 2009 Budget in Brief* at 54. These dollar amounts reflect the allocation of the Operations Support budget to the Taxpayer Services and Enforcement categories.

[13] *Id.* at 53.

lion to $617 million—a reduction of 4.34 percent in nominal terms and a larger reduction after taking into account inflation.[14]

I am deeply concerned about this long-term shift in the balance between taxpayer services and enforcement and the fact that only 6 percent of the IRS budget is devoted to pre-filing taxpayer assistance and education, which I view as core taxpayer service. There is no reliable data showing that more enforcement is more effective than more taxpayer service in increasing compliance. I believe the IRS can produce a positive return on investment from more funding in both areas. But given limited resources, I think it is misguided to continue to ramp up enforcement at the expense of taxpayer service.

The concerns I am expressing about the relative shift in emphasis from taxpayer service to enforcement do not reflect simply the misgivings of a zealous taxpayer advocate. My concerns are shared by former IRS Commissioner Rossotti. In a memoir about his experience running the IRS from 1997 to 2002, Mr. Rossotti wrote:

> Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.[15]

At his confirmation hearing, Commissioner Shulman said that he believes the choice between service and enforcement is a "false choice" because the IRS must do both well.[16] I agree completely. But the IRS needs adequate funding in both areas to do the job.

The IRS Has Improved Its Research in Recent Years, But Significant Improvements Are Still Needed

Research plays a vital role in helping the IRS make the major strategic and operational decisions needed to effectively administer the tax system. Just as R&D is critical to a technology company as it seeks to improve the products and services it provides to customers, tax administration-related research is critical to the IRS as it seeks to meet taxpayer service needs and improve tax compliance in a cost-effective manner. For that reason, I have consistently advocated for a more robust IRS research capability.

The IRS has more information available today than it did 5 years ago, particularly in the area of taxpayer service because of ongoing work in connection with the Taxpayer Assistance Blueprint. However, the IRS should continue to expand its available knowledge and should make research an integral part of its next strategic plan. In particular, the IRS should make it a priority to improve the accuracy of its return on investment (ROI) estimates for various categories of work, particularly taxpayer service and the indirect effect of enforcement actions. Improved methods should also be developed to verify, retrospectively, the marginal ROI that the IRS has achieved for major categories of its work. Such information would be extremely helpful in guiding future resource-allocation decisions.

Because of the value I place on research, TAS has initiated or worked with the IRS to conduct taxpayer-centric research on enforcement and service issues. Some of these projects have been undertaken in response to Appropriations directives. For example, TAS Research is currently working with the central IRS research function and the research functions in the IRS's Wage & Investment and Small Business/Self-Employed Divisions to develop and implement a 5-year research plan to enhance taxpayer service in support of the Taxpayer Assistance Blueprint initiative. TAS Research is collaborating with the IRS research community to develop a 5-year research plan directly supporting enterprise-wide strategic goals. TAS Research is working with the central IRS research function to identify and quantify the numerous factors that impact taxpayer compliance behavior. TAS Research is working with the Office of Electronic Tax Administration and Refundable Credits to study alternatives for increasing electronic filing, and will work with the IRS's National Research Program to conduct research into the causes of noncompliance (whether advertent or inadvertent).

In addition, TAS Research is involved in a number of other initiatives addressing significant tax administration issues, such as:

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[14] Department of the Treasury, *Fiscal Year 2009 Budget in Brief* at 53.

[15] Charles O. Rossotti, Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America 285 (2005).

[16] Hearing Before the S. Comm. on Finance, 110th Cong. (2008) (Jan. 29, 2008) (statement of Douglas H. Shulman).

—A collaborative effort with the research function in the Wage & Investment Division to explore development of a filter for the Federal Payment Levy Program to protect low income taxpayers from systemic levies;
—A collaborative effort with the Office of Program Evaluation and Risk Analysis (OPERA) to explore new applications of "agent-based modeling," a technology that simulates taxpayer behavior in social networks, to tax administration issues;[17]
—A collaborative effort with the IRS research community to explore ways to positively influence the impact practitioners and preparers have on taxpayer compliance; and
—Ongoing research by an independent contractor into the impact preparers have on taxpayer compliance.[18]

In Volume 2 of the 2007 National Taxpayer Advocate's Annual Report to Congress, I published a comprehensive literature review of the cognitive and normative factors that influence taxpayer compliance behavior.[19] In another section of the report, I adopt the central recommendation of the study—that the IRS should establish a cognitive learning and applied research laboratory to explore how taxpayer values, social norms, and cognitive processes influence taxpayers' compliance.[20]

Toward that end, TAS Research is proposing a survey conducted as a component of the National Research Program (NRP), in which an independent firm surveys taxpayers who were subjects of NRP audits and explores the causes of any detected noncompliance and the factors influencing taxpayer compliance behavior. This information, combined with the compliance data from the NRP audits themselves and the observations of IRS auditors about the reasons for the detected noncompliance, should provide a rich resource for future studies and initiatives, and should improve the IRS's ability to improve taxpayer compliance.[21]

I cite these studies as important examples of research studies that I hope and expect will improve the IRS's ability to serve taxpayers and collect revenue. However, these studies are merely a starting point. If the IRS has better information, it can make more informed resource allocation decisions. Absent clear information, the IRS unavoidably bases its resource allocation decisions on intuition and bases its best guesses on incomplete data, and that is obviously not an ideal way to make decisions.

The IRS Is Paying More Attention to Taxpayer Services, But Significant Challenges Remain

In 2006, Congress directed the IRS to prepare a Taxpayer Assistance Blueprint (TAB), which was released last April.[22] The TAB was intended to serve as a strategic plan for taxpayer service and lead to the development of taxpayer-centric, research-based models to help the IRS make decisions about taxpayer service and the delivery of face-to-face service. Because of the TAB and my own office's research,

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[17] National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Study: Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study).

[18] National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Study: Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws).

[19] National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Study: Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers).

[20] *See* National Taxpayer Advocate 2007 Annual Report to Congress 158 (Most Serious Problem: Taxpayer Service and Behavioral Research).

[21] For an example of how one might conduct such a study and an interesting analysis of some of the attitudinal and knowledge factors that might impact taxpayer compliance in a self-assessment tax system, see Ern Chen Loo, Margaret McKerchar, & Ann Hansford, *An International Comparative Analysis of Self-Assessment: What Lessons are there for Tax Administrators?*, 20 Australian Tax Forum 667 (2005).

[22] H. Rep. No. 109–307, at 209 (2005). The Senate Committee Report provides further detail on the content of the 5-year plan, directing the IRS to: ". . . undertake a comprehensive review of its current portfolio of taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers. This plan should detail how it [IRS] plans to meet the service needs on a geographic basis (by State and major metropolitan area), including any proposals to realign existing resources to improve taxpayer access to services, and address how the plan will improve taxpayer service based on reliable data on taxpayer service needs. As part of this review, the Committee strongly urges the IRS to use innovative approaches to taxpayer services, such as virtual technology and mobile units. The IRS also should expand efforts to partner with State and local governments and private entities to improve taxpayer services. S. Rep. No. 109–109, at 134 (2005).

we know more than ever about taxpayers' needs and preferences, and their willingness to try new methods of service delivery.[23]

Over the last 2 years, the IRS has begun to reverse its trend in recent years of limiting the types of services and methods of delivery. I applaud the IRS for creating a Services Committee—the counterpart to the Enforcement Committee—thereby enabling the entire IRS senior leadership to consider and coordinate taxpayer service initiatives. The IRS currently is undertaking many initiatives to assist taxpayers in claiming economic stimulus payments, including keeping the IRS's walk-in sites—known as Taxpayer Assistance Centers, or TACs—open on more Saturdays during the filing season. I am also pleased that IRS management has indicated a willingness to consider reinstating Problem Solving Days and taking a geographic approach to determining which topics to designate as "out-of-scope" (e.g., the IRS should not treat farm-related questions as "out-of-scope" in TACs located in areas where there is a significant amount of farming activity). The IRS has also recently relaxed its stringent rules that generally prevented taxpayers from obtaining copies of their tax return transcripts at the TACs.[24]

It remains to be seen, however, whether the IRS will dedicate the resources—both in terms of personnel, dollars, and priorities—necessary to make the TAB a reality. I discuss a few of my concerns below.

Sustained Funding for Taxpayer Services Is Crucial to Meeting Taxpayer Needs

Any reduction in the IRS's taxpayer service budget presents a significant challenge to implementation of the TAB. In fact, taxpayer service funding should be increased so that, while the IRS continues to deliver its traditional services, programs developed by the TAB team are not just piloted but are instead fully implemented. For example, this filing season the IRS is piloting an approach in the TACs called "Facilitated Self Assistance." Under this model, taxpayers who come to certain TACs for assistance may carry out designated service tasks on IRS.gov or the IRS phone system with the help of a live IRS assistor. Preliminary feedback from the 15 TACs offering Facilitated Self-Assistance has been positive. Without sufficient funding, however, the IRS will be unable to expand the pilot testing, let alone fully implement the program, no matter how successful it might be. If the financial support for taxpayer service is not sufficient, the TAB process will have been for naught—having produced many interesting ideas and important research that simply cannot be implemented or applied.

Internet Services Are Important, But They Cannot Be the Only Game in Town

Insufficient funding increases the temptation for the IRS to put all its eggs in one basket when it comes to taxpayer service—namely, self-assisted Internet services. The Internet may be adequate for taxpayers who are comfortable handling financial transactions online, but the TAB's research studies showed that a certain percentage of taxpayers, and particular types of tax issues, require personal interaction—by telephone, face-to-face, or both.

For example, we now know that nearly 25 percent of taxpayers do not have Internet access.[25] Additionally, more than 25 percent of taxpayers stated that they are unwilling to use the IRS website for any service activities in the future.[26] Among taxpayers who used IRS services between mid-2004 and mid-2006, about 45 percent of those who called the IRS and more than 75 percent of those who visited the IRS stated they would not use the IRS website. When probed further as to why they would not use the website, more than half gave a reason that suggests they could not use the website due to lack of computer equipment, Internet access or computer savvy.[27] Approximately 75 percent of taxpayers stated they do not feel comfortable

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[23] *See* National Taxpayer Advocate 2006 Report to Congress, vol. 2 (Research Study: Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

[24] Previously the IRS required taxpayers to obtain transcripts of their accounts through the toll-free service, which would mail a transcript within seven to ten days. Taxpayers could only obtain transcripts at TACs in "emergency" situations. It was TAS's experience that the TACs almost never acknowledged an emergency situation. In fact, since that policy was in place, TAS transcript cases have increased sharply. The IRS's more flexible transcript policy should result in fewer TAS cases in this area.

[25] W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006—Question 7—22.5 percent–24.6 percent.

[26] W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006—Question 8—25.3 percent–27.4 percent.

[27] IRS Oversight Board, *2006 Service Channels Survey*, Questions 17, 19 & 20: About 50 percent (42.5 percent-57.5 percent) of taxpayers who called or visited the IRS are unwilling to use IRS.gov (*i.e.*, 37.2 percent-52.7 percent of those who called and 60.5 percent-92.7 percent of those who visited the IRS stated they would not use the IRS Internet site). More than 23 percent of

sharing personal information via the Internet.[28] Approximately 12 percent of taxpayers have some type of disability,[29] and about 6 percent of taxpayers speak a language other than English at home.[30]

The IRS has an obligation to provide services through methods that will assist all taxpayers. The IRS must therefore maintain and improve its telephone and face-to-face services for as long as there is a segment of the population that needs it—which, given the complexity of the tax law and IRS procedures, will be as far into the future as I can see.

The IRS Should Expand and Improve the Services Provided by Taxpayer Assistance Centers

For several years I have highlighted problems with the IRS's delivery of face-to-face taxpayer services in the TACs.[31] In my 2007 Annual Report to Congress, I identified several problems that limit the usefulness of the TACs, including the insufficient number and staffing of TACs and the significant conditions for obtaining return preparation assistance that have the effect of deterring taxpayers from seeking service.

The Location and Number of TACs May Not Be Adequate

In 2001, the IRS committed to opening 118 new TACs in the following seven to 8 years.[32] Unfortunately, none of these new TACs was opened, and the IRS even initiated an unsuccessful effort to close 68 TACs.[33] The TAB concluded that TAC offices were adequately serving only 60 percent of the United States population.[34] In order to make better decisions about the location, number, and staffing of TACs, the IRS developed a decision tool about TAC operations. However, that tool only includes the present TAC locations. It is not clear whether the IRS will use this program to consider adding TAC locations, even though TAB research demonstrates that TAC coverage across the United States is insufficient. Thus, we recommend that the IRS conduct additional research of population segments to determine the volume, scope, and type of services that taxpayers require by geographical location, and utilize its TAC decision tool to identify the most appropriate number and placement of TACs.

TAC Staffing and the Availability of Services Are Inadequate To Meet Taxpayer Needs

Only 55 percent of TACs are open for 36 to 40 hours per week, and during the last 3 years, the IRS reduced TAC staffing by 9 percent, leaving most TAC offices with staffing shortages.[35] Although the IRS is now hiring seasonal workers to ease the staffing crunch, I believe the IRS should make a firm commitment to providing TACs with the level of staffing necessary to meet taxpayer needs.

The IRS Should Meet its Fundamental Tax Administration Responsibility To Provide Tax Return Preparation Assistance for Low Income Taxpayers

I am concerned that the IRS imposes too many barriers and limitations on tax preparation. I am pleased that the IRS heeded our earlier criticism and has changed its position on requiring taxpayers to visit a TAC twice in order to obtain return

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taxpayers called or visited the IRS between mid-2004 and mid-2006, which translates to roughly 32 million taxpayers (based on a filing population of slightly less than 135 million). About half of taxpayers who use IRS phone or TAC services, approximately 16 million taxpayers, are unable or unwilling to use the Internet. IRS, *2006 Filing Season Statistics*, Cumulative Through 10/27/06, Individual Income Tax Returns total receipts = 134,919,000.

[28] IRS Oversight Board, *2006 Service Channels Survey*, Question 11: 70.2 percent-76.2 percent do not feel comfortable sharing personal information over the Internet. Reasons include privacy concerns (33.4 percent-40.8 percent) and Internet security issues (41.9 percent-49.6 percent).

[29] W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006, Question 19: 87.2 percent-88.7 percent of taxpayers do not have a disability.

[30] W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006, Question 20: 5.4 percent-6.8 percent of taxpayers speak a language other than English.

[31] See National Taxpayer Advocate 2007 Annual Report to Congress 162–182 (Most Serious Problem: Service at Taxpayer Assistance Centers), *see also* National Taxpayer Advocate 2006 Annual Report to Congress xi–xiv (Taxpayer Assistance Blueprint: The National Taxpayer Advocate's Perspective); National Taxpayer Advocate 2005 Annual Report to Congress 2–24 (Most Serious Problem: Trends in Taxpayer Service); National Taxpayer Advocate 2004 Annual Report to Congress 8–66 (Most Serious Problem: Customer Service in a Complex and Changing Tax Environment).

[32] National Taxpayer Advocate 2001 Annual Report to Congress 49.

[33] IRS News Release, *IRS to Create Efficiencies with Taxpayer Assistance Centers*, IR–2005–63 (June 27, 2005).

[34] Internal Revenue Service, *Taxpayer Assistance Blueprint: Phase 2*, at 116 (Apr. 17, 2007).

[35] Information obtained from IRS Wage & Investment Division (Field Assistance function) (September 2007).

preparation services—once to make the appointment and once to have the return prepared. However, the IRS continues to downplay its own role in tax preparation.

To my mind, tax preparation is a core service for the tax administrator. The tax administrator cannot look to the nonprofit sector alone to meet the needs of the millions of low income taxpayers, including many elderly taxpayers, who cannot afford to pay a return preparer. Yet the IRS continues to straddle the line—it prepares enough returns to allow it to claim it is providing the service but makes it very difficult in some cases for taxpayers to obtain assistance. For example, the IRS has declared returns involving cancellation of debt income "out of scope" both for the TACs and for volunteer preparation sites,[36] even though those subjects are highly likely to impact the very taxpayers who are eligible for TAC services (whether because of credit card debt forgiveness or home foreclosures). Thus, these low income taxpayers have no alternative but to pay for return preparation, something they generally cannot afford to do.

It is not just individual taxpayers who suffer from this restriction on preparation services in the TACs. Today, organizations exempt from tax under IRC § 501(c)(3) are generally required to file an e-postcard annually if their gross receipts are normally $25,000 or less, providing the IRS with basic contact information and informing the IRS whether the organization is still a going concern.[37] Failure to file for 3 consecutive years will result in automatic revocation of the organization's exempt status.[38]

Approximately half of exempt organizations have all-volunteer staffs and another third have fewer than 10 employees.[39] These smaller nonprofits frequently lack professional tax guidance and rely on their volunteers to deal with the IRS.[40] Yet the TACs have agreed to assist exempt organizations with filing the e-postcard on the condition that the IRS not publicize the availability of this assistance. Thus, the only way a small exempt organization will know whether the IRS will help it is if it happens to visit a TAC on its own initiative. This "we will provide you service but we won't tell you about it" approach falls well short of the level of service the public has a right to expect from its Government.

The IRS Should Explore Alternative Methods of Delivering Face-to-Face Services

In 2003, the IRS committed to providing alternative methods of service to taxpayers.[41] Among the ideas proposed were alternative locations to brick-and-mortar TACs and mobile units specifically tailored to the needs of the communities they serve.[42] I support these ideas, and I strongly encourage the IRS to pursue them and to explore other service methods as well. For example, the IRS should partner with State tax agencies, or other service-oriented Government agencies such as the Social Security Administration, to provide one-stop shopping for taxpayers. Additionally, the IRS could co-locate with other agencies, both State and Federal, to offer services targeting a specific taxpaying population (e.g., co-locate with Departments of Motor Vehicles to offer excise fuel tax assistance to truck drivers).

I commend the IRS's recent coordination of "Super Saturday" to assist taxpayers in filing economic stimulus payment returns. The IRS should replicate that approach in similar efforts targeted at other groups of taxpayers. The IRS previously sponsored "Problem Solving Days," where taxpayers could receive assistance on any tax issue and potentially have their problems resolved with one contact. The IRS should bring back Problem Solving Days using Super Saturday as a model and aggressively market the effort to taxpayers. Other initiatives could include National Filing Days, which I recommended in my 2007 Annual Report to Congress, where taxpayers who are currently not in compliance with their tax obligations could come to the IRS and be brought into compliance.[43]

The IRS Should Expand Outreach and Education in the Exempt Organization Sector

If the IRS is to increase compliance by exempt organizations (EOs), more resources must be devoted to outreach to, and education of, these organizations. I commend the Tax Exempt and Government Entities (TE/GE) Division's Customer Edu-

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[36] IRS Small Business/Self-Employed Division, Response to TAS Information Request (Oct. 30, 2007).
[37] IRC § 6033(i); IRC § 6033(a)(3)(B); Announcement 82–88, 1982–25 I.R.B. 23.
[38] IRC § 6033(j).
[39] IRS, TE/GE Fiscal Year 2005 Strategic Assessment 3 (Feb. 2, 2005).
[40] *Id.*
[41] National Taxpayer Advocate 2003 Annual Report to Congress 149.
[42] *Id.*
[43] National Taxpayer Advocate 2007 Annual Report to Congress 257.

cation and Outreach (CE&O) office for its existing efforts to address the needs of EOs. CE&O has done much with few resources, but it cannot adequately carry out its mission without better funding. TE/GE allocated only approximately $1.2 million or 1.4 percent of its $85.4 million fiscal year 2007 EO budget to education and outreach.[44] The number of EO education and outreach full-time equivalents (FTEs) has stagnated at approximately 12 for the last three fiscal years[45] while the number of EOs has grown by more than 70,000 per year.[46] Twelve FTEs are simply not enough to carry on the important work of EO education and outreach, regardless of how cost-effective and innovative the IRS's outreach methods may be.

TE/GE has leveraged its limited EO education and outreach resources through increased use of electronic means. Electronic education and outreach is an excellent tool that should be used in conjunction with, but not supplant, face-to-face and non-electronic outreach. For example, the Charities and Non-Profits page of the IRS website contains many useful materials, but the IRS needs to proactively distribute hard copies of those materials through partners and outreach sessions rather than wait for EOs to find and view them online. Moreover, the IRS must obtain better data on EOs' access to the Internet, how EOs use the Internet, and EOs' willingness and ability to change how they use the Internet before investing further in electronic education and outreach.

IRS Daily Delinquency Penalty (DDP) abatement rates reveal that there is great potential to reduce noncompliance with more education and outreach. The IRS may assess a DDP when an EO files an information return with missing or incorrect information[47] but will abate the DDP if the penalized organization later supplies the missing information or corrects the error and shows reasonable cause for the mistake.[48] Between 2000 and 2005, the IRS abated almost 62 percent of all assessed DDPs and nearly 68 percent of all assessed DDP dollars (nearly $857 million).[49] A study conducted by the IRS in 2003 found that most assessed DDPs were attributable to organizations' failure to include Schedules A and B with their returns.[50]

The annual cycle of DDP assessment and abatement is not good for anyone. EOs that receive DDP assessments due to curable errors must use their resources to get the IRS to abate the penalty. Alternatively, they may simply pay the penalties to avoid dealing with the IRS but are likely to be penalized again if they do not work with the IRS to find out why the penalties were assessed. The DDP assessment/abatement cycle also wastes IRS resources. When more than 60 percent of all assessed DDP penalties are abated, IRS employees are spending significant time determining whether the mistakes that gave rise to the assessments were attributable to reasonable cause.

To Reduce the Tax Gap, the IRS Should Place More Emphasis on Combating Noncompliance in the Cash Economy

As you know, the gross "tax gap"—the amount of tax that is not voluntarily and timely reported and paid—stood at an estimated $345 billion in 2001 and remains a serious problem.[51] As a result, households that comply with their tax obligations effectively pay a "surtax" averaging about $2,680 per year to subsidize noncompliance by others.[52] Where taxable payments are reported to the IRS by third parties,

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[44] Information received from Tax Exempt/Government Entities Division (Nov. 7, 2007).

[45] Information received from Tax Exempt/Government Entities Division (Nov. 6, 2007); IRS, *Tax Exempt and Government Entities Business Performance Review* 21 (May 9, 2007).

[46] Remarks of Steven T. Miller, Commissioner, IRS Tax Exempt and Government Entities Division, before the Philanthropy Roundtable (Dec. 10, 2007).

[47] IRC § 6652(c)(1)(A).

[48] IRC § 6652(c)(4).

[49] IRS Enforcement Revenue Information System (ERIS) and Statistics of Income (SOI) for EO Returns, 2000–2005 DDP assessments and abatements. *See also* National Taxpayer Advocate 2006 Annual Report to Congress 491 (Legislative Recommendation: Increase the Exempt Organization Information Return Filing Threshold).

[50] Ogden Form 990 Study, Attachment to Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (Oct. 2003).

[51] The gross tax gap is the amount of tax that is imposed by law for a given tax year, but not voluntarily and timely paid. The net tax gap is the portion of the gross tax gap that remains uncollected after taking into account late payments and IRS enforcement actions for a given tax year. The 2004 IRS National Research Program study estimated the 2001 gross tax gap at $345 billion and the net tax gap at $290 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007), *available* at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf. These figures do not include unpaid tax on income from illegal activities.

[52] If we divide the estimated 2001 net tax gap of $290 billion by the estimated 108,209,000 U.S. households in 2001, we see that each household was effectively assessed an average "surtax" of about $2,680 to subsidize noncompliance. *See* U.S. Census Bureau, Population Division (data as of Mar. 2001).

taxpayers generally report well over 90 percent of their income.[53] By contrast, where taxable payments are not reported to the IRS by third parties, reporting compliance drops below 50 percent.[54] Therefore, it should come as no surprise that underreported income from the "cash economy"—which, for tax administration purposes, we define as taxable income from legal activities that is not subject to information reporting or withholding—is probably the single largest component of the tax gap, likely accounting for over $100 billion per year.[55]

Noncompliance in the cash economy merits special attention because the IRS's traditional enforcement tools such as document matching and audits are less effective when there is no third-party reporting, and also because it is growing. According to one study, the percentage of all income subject to third-party information reporting fell from 91.3 percent in 1980 to 81.6 percent in 2000.[56] The IRS's filing projections suggest that the cash economy and the amount of unreported income may continue to grow.[57]

The IRS Should Establish a Cash Economy Program Office To Increase the Effectiveness of its Efforts

In my 2007 Annual Report to Congress, I proposed a comprehensive strategy to address the cash economy portion of the tax gap that consisted of 15 administrative recommendations and seven legislative recommendations.[58] As a threshold matter, I believe the IRS should establish a Cash Economy Program Office. The office would have responsibility for coordinating efforts to improve compliance in the cash economy. At present, there is no single unit or executive within the IRS with responsibility for ensuring that enforcement, research, and educational activities aimed at the cash economy are implemented in a coordinated fashion. The IRS uses a coordinated approach to address certain other issues—an example being the EITC Program Office—and I believe a program office would help the IRS address the cash economy as well. Such an office would bring accountability to the effort because it could measure its success based on the impact of IRS initiatives on compliance by cash economy participants.[59] Absent a strategic, coordinated approach, the IRS is less likely to make progress in reducing noncompliance in the cash economy.

The IRS Should Research the Most Effective Use of Its Audit Resources

In addressing the cash economy, the IRS should also leverage its limited audit resources by investing in research to identify the most effective uses of these resources after taking into account the direct and indirect effects of IRS activities on tax revenue. In addition to the direct revenue that audits generate from the taxpayer for the period(s) under audit, as discussed above, economists estimate the indirect effects or "ripple effects" of an audit on voluntary compliance by other taxpayers or by the same taxpayer in future periods provide even greater revenue

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[53] See IRS News Release, *IRS Updates Tax Gap Estimates*, IR–2006–28 (Feb. 14, 2006) (accompanying charts), *available* at http://www.irs.gov/newsroom/article/0,,id=154496,00.html.

[54] *Id.*

[55] *Id.* Underreporting makes up about 83 percent of the tax gap ($285 billion of the $345 billion gap). Underreporting of business income by individuals—from sole proprietors, rents and royalties, and pass-through entities—accounted for about $109 billion. Associated underreporting of self-employment taxes by unincorporated businesses accounts for another $39 billion. *Id.*

[56] Kim Bloomquist, *Trends as Changes in Variance: The Case of Tax Noncompliance*, presented at the 2003 IRS Research Conference (June 2003) (citing growth in capital gains, partnership, and small business income).

[57] The IRS expects the number of individual returns from small business or self-employed taxpayers to grow by about 33 percent between 2006 and 2014, while the number of individual returns from other taxpayers is expected to decline by about 2 percent over the same period. IRS Office of Research, Research, Analysis and Statistics, Document 6292, *Fiscal Year Return Projections for the United States, 2007–2014* (Sept. 2007), *available* at http://www.irs.gov/pub/irs-soi/d6292.pdf.

[58] *See* National Taxpayer Advocate 2007 Annual Report to Congress 35–65 (Most Serious Problem: The Cash Economy), 490–502 (Legislative Recommendation: Measures to Address Noncompliance in the Cash Economy), and vol. 2, at 1–43 (Research Study: A Comprehensive Strategy for Addressing the Cash Economy).

[59] The Treasury Inspector General for Tax Administration and the Government Accountability Office both generally agree that measures that promote accountability would help the IRS reduce the tax gap. *See, e.g.*, Government Accountability Office, GAO–06–208T, *Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005); Written Statement of Russell George, Treasury Inspector General for Tax Administration, *Hearing Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies on the Internal Revenue Service's Fiscal Year 2006 Budget Request* (Apr. 7, 2005).

gains.[60] The IRS needs more and better research on how best to use limited audit resources to improve compliance in the cash economy. For example:

—Should the IRS use more correspondence examinations or face-to-face examinations in cash economy industries? Does the answer depend on the industry?

—To achieve the greatest impact, should audits be clustered either geographically or within industries, so as to generate maximum publicity and possibly change local or industry norms, or should audits be more spread out in a dispersed pattern of "touches"?

—Do audits have an even greater "ripple" effect on compliance when coupled with outreach and education targeted at unaudited members of the same community?

My other recommendations fall into four broad categories: (1) making compliance easier, (2) increasing income visibility and the productivity of audits, (3) increasing the focus on preparers, and (4) identifying areas where additional research is needed to help the IRS understand how it can efficiently improve voluntary compliance.[61]

The Private Debt Collection Initiative Will Cost the Federal Government at Least $81 Million in Foregone Revenue Annually and Should Be Terminated

In my Annual Reports to Congress and in prior testimony, I have expressed serious concerns about many aspects of the private debt collection (PDC) initiative, including the potential for violations of taxpayer rights, the fact that private collection agency (PCA) procedures are less transparent to the public—and to congressional oversight—than IRS procedures, and the evidence that the so-called "simple" cases on which the program was initially promoted do not exist in significant numbers.[62]

I now add to these concerns the issue of foregone revenue. Very simply, the PDC initiative will cost the Government more than $81 million in foregone revenue this year, and the cost is likely to reach nearly a half billion dollars over the next 6 years. I explain below how I arrive at this conclusion.

The IRS projects that it will use $7.65 million in appropriated funds in fiscal year 2008 to administer the PDC program, and it anticipates relatively steady costs in future years.[63] At the same time, the IRS estimates that the program will generate gross revenue averaging about $23 million this year and next,[64] and it is unlikely that gross revenue will increase in future years unless the nature of the program changes significantly. By these calculations and after subtracting the direct costs of the program ($7.65 million) and commissions payable to the PCAs (about $4.60 million), the program can be expected to yield annual net revenue of about $11 million. Thus, an annual IRS expenditure of $7.65 million will produce annual net revenue of about $11 million, which translates to about a 1.45:1 net return on investment (ROI).[65]

If the PDC program did not exist and the IRS instead allocated $7.65 million in appropriated funds to its Automated Collection System (ACS) function, the ROI would be substantially higher. IRS data shows that the average ROI for the ACS program is about 20:1, which means an expenditure of $7.65 million would generate annual revenue of $153 million.[66] In testimony before the House Ways and Means

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[60] *See, e.g.*, Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 35–36 (Oct. 1996).

[61] *See* National Taxpayer Advocate 2007 Annual Report to Congress 35–65 (Most Serious Problem: The Cash Economy), 490–502 (Legislative Recommendation: Measures to Address Noncompliance in the Cash Economy), and vol. 2, at 1–43 (Research Study: A Comprehensive Strategy for Addressing the Cash Economy).

[62] *See* National Taxpayer Advocate 2007 Annual Report to Congress 411–431 (Status Update: Private Debt Collection); National Taxpayer Advocate 2006 Annual Report to Congress 34–61 (Most Serious Problem: True Costs and Benefits of Private Debt Collection) and 458–462 (Legislative Recommendation: Repeal Private Debt Collection Provisions); *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

[63] E-mail from Director, PDC Program Office, to TAS Attorney Advisor (Feb. 29, 2008).

[64] *Id.*

[65] As discussed in the text below, the data I have cited actually overstate the likely ROI because the IRS's cost estimates are not comprehensive (*e.g.*, they do not include the time that Taxpayer Advocate Service case advocates spend assisting taxpayers who request our help with PDC cases or the time senior IRS executives must devote to studying, monitoring, and answering continual questions about the program) and the IRS's revenue estimates include funds that the IRS collects on the basis of its initial letter—before the PCAs make any contact with the taxpayers.

[66] We have computed the full cost of an average ACS employee at slightly less than $75,000 (assuming GS–8, step 5). The current average amount collected by an ACS employee per year

Continued

Committee last May, Acting Commissioner Kevin Brown placed the ACS ROI somewhat lower, at about 13:1.[67] Even accepting the lower figure, a 13:1 ROI on an expenditure of $7.65 million would produce gross revenue of $99.45 million and net revenue (after subtracting the $7.65 million expenditure) of $91.8 million.

Thus, the IRS's expenditure of $7.65 million in appropriated funds is generating about $11 million in net revenue when applied to the PDC program but should generate at least $91.8 million if applied to its ACS collection function. In other words, the opportunity cost of spending $7.65 million of appropriated funds on the PDC program each year is $81 million, and possibly much more.

Since the purpose of private debt collection is to raise revenue, the fact that it is costing the Government $81 million or more each year destroys whatever thin rationale might remain for its existence.

The $7.65 Million Cost Estimate for the PDC Program Fails to Capture Significant Costs

In addition to consuming $7.65 million in annual operating costs, the PDC program required $70 million in start-up costs. The IRS previously estimated that it would recoup these "sunk" costs in fiscal year 2008 but now acknowledges that fiscal year 2010 is the earliest point at which the initiative is likely to "break even."[68] Moreover, as of September 2007, the IRS had 54 employees (and this total does not include Modernization & Information Technology Services (MITS) infrastructure or TAS case working employees) working on the initiative and overseeing 62 employees from the PCAs.[69]

The annual expenditure of $7.65 million is significant for an initiative that is failing in most respects. Additionally, we have learned that the $7.65 million cost estimate provided by the IRS does not include numerous expenses. The $7.65 million cost estimate includes PDC-related costs incurred by the IRS referral unit and most IRS headquarters staff as well as costs incurred by MITS for support and by TAS to cover the cost of one employee assigned to work with the PDC Project Office. However, the $7.65 million cost estimate does not include the PDC-related costs incurred by the IRS Office of Chief Counsel, which is periodically consulted for legal advice; the IRS Office of Legislative Affairs, which has spent considerable time presenting the program to Members and Committees of the Congress and responding to inquiries; by TAS for working with more than 1,500 taxpayers who have sought our assistance on PCA-related cases; or by other IRS functions that have helped to support the program.[70] We have been unable to obtain a complete estimate of the costs of the program.

The IRS's Own Collection Actions Account for a Significant Portion of the PDC Program's Full-Paid Accounts

Almost half—specifically, 46 percent—of the fully paid liabilities included in PDC gross revenue has been collected through offsets or direct payments made by the taxpayer after receiving a letter from the IRS informing the taxpayer that his or her account would be placed with a PCA but before the PCA made contact with the taxpayer.[71] These fully paid liabilities are a direct result of IRS action—not action taken by a PCA.

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is about $1.53 million. That volume of collection translates to a return-on investment on the average ACS employee of about 20:1.

[67] *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (May 23, 2007) (testimony of Kevin M. Brown, Acting Commissioner of Internal Revenue).

[68] *The 2008 Filing Season: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (Mar. 13, 2008) (testimony of Linda E. Stiff, Acting Commissioner of Internal Revenue).

[69] IRS Response to Information Request on PDC Initiative (Sept. 2007).

[70] IRS Response to TAS Request for Information (April 10, 2008).

[71] The 46 percent of fully paid liabilities includes payments received by the IRS through the following means: (a) dollars received by the government 10 calendar days or less after the IRS transferred the account to the contractor; (b) unidentified payments (*i.e.*, payments that cannot be matched and posted to a debtor's account within the contractor's inventory of accounts); (c) dollars collected in excess of an individual's balance, resulting in overpayment by the debtor; (d) dollars received on any account 11 calendar days or more after the account was returned to the IRS except as specifically described by contract; and (e) dollars received through Federal, State or local administrative, tax refund, salary, Treasury offset, Federal Levy payment or other type of offset or other administrative action which results in the reduction or elimination of the debt in a manner beyond the scope of the contractor's performance. IRS, Request for Quotation, Request No. TIRNO–05–Q–00187, at 22 (¶A.4.1). The National Taxpayer Advocate's 2006 Annual Report to Congress reported that, while the IRS would not send accounts to private collectors that were already subject to levy under the Federal Payment Levy Program (FPLP), the IRS would not recall accounts already assigned to a PCA if the account becomes subject to an FPLP levy after assignment. National Taxpayer Advocate 2006 Annual Report to Congress 43. When the IRS first described its vision of the PDC program to Congress, the IRS maintained

Moreover, more than half of the payments received by the PDC initiative are fully paid liabilities.[72] In many of these cases, the IRS had taken no action on the accounts after its standard "notice stream" had run its course. However, these data seem to indicate that if the IRS were to spend 41 cents on a letter to taxpayers sometime after the end of the standard notice stream to say, in effect, "Hello, we're back," the IRS could obtain a meaningful return.

The Inventory of "Easy" Cases for PCAs To Work Has Largely Dried Up

The PDC initiative has taken several steps to address the lower than expected revenue, which are deviations from the original intent of the initiative.[73] Because the number of "easy" cases was also smaller than expected, the IRS began to include older inventory which is more difficult to resolve.[74] The IRS is still searching for other types of cases to hand over to the PCAs, many of which are complex, require discretion, and are already being worked by the IRS's own collection function. For example, the IRS is studying the feasibility of assigning cases in which the taxpayer has not agreed to the entire outstanding tax liability.[75] The IRS is also considering placing with the PCAs cases that ACS is currently working, and it is studying 1,500 modules to identify cases that it can move from actual IRS ACS inventory to the PCAs.[76] Thus, the IRS is now proposing to give the PCAs the types of cases that the IRS itself is already working and could continue to work at a greater rate in the future. Placing these types of cases with the PCAs is precisely the opposite of the premise on which the program was sold—namely, giving PCAs only the easy cases the IRS itself otherwise would not work.[77]

The IRS Has Left Cases in the Control of PCAs for Much Longer Than It Originally Intended

The IRS's concern about the PDC initiative's low revenue might have influenced the IRS decision to extend the timeframe for which unresolved cases from the initial stage of the PDC program (known as Release 1.1) will remain with the PCAs.[78] Initially, the IRS planned to recall taxpayer accounts after 12 months.[79] However, the IRS extended the recall to 18 months and now has extended it until the collection curve on these cases declines, but it is not clear how significant the decline must be for the recall to begin.[80] Nor is it clear how frequently the PCAs attempt to collect on these cases or whether the taxpayers would be better off if their cases were sent back to the IRS.

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that cases under enforcement action were not the types of cases that would be referred to private collectors. *Private Debt Collection: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (testimony of Commissioner Mark W. Everson). As a consequence of the IRS's decision to leave FPLP cases with private collectors, private collectors are contacting taxpayers whose Social Security payments are already under active FPLP levies and are demanding full payment of the tax liability.

[72] IRS, *Filing Payment Compliance Advisory Council* (April. 14, 2008) at 3.

[73] Former Commissioner Mark Everson testified: "Private collectors will work the easy cases, thereby ensuring that they will not engage in 'inherently governmental' activities and that the IRS will be able to focus on more complex work." *Private Debt Collection: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (statement of Commissioner Mark W. Everson). I also testified to that point: "The IRS has stated that it will only send to PCAs those cases that meet the following criteria: (1) the taxpayer has either agreed to the tax debt and/or has made three or more payments toward that debt; *and* (2) the taxpayer appears to have the ability to pay this debt in full immediately or within 36 months. It is vital to the success of this proposal that only those cases that fit these parameters are selected and referred to the PCAs." *IRS Use of Private Debt Collection Agencies by the IRS: Hearing Before the Subcomm. on Oversight of the H. Comm. Ways and Means*, 108th Cong. (May 13, 2003) (statement of Nina E. Olson, National Taxpayer Advocate).

[74] The IRS had to remove 15,500 cases from the initial inventory of 42,800 cases that would possibly have been assigned to private collectors. These cases were removed because the taxpayer had previous shelved delinquencies. IRS, *Filing & Payment Compliance Advisory Council Presentation* 9 (July 31, 2006).

[75] IRS, *Filing and Payment Compliance Advisory Council* (Jan. 14, 2008) at 7.

[76] IRS, *Filing and Payment Compliance Advisory Council (Feb. 11, 2008) at 10.*

[77] *Private Debt Collection: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (testimony of Commissioner Mark W. Everson).

[78] IRS, *Filing and Payment Compliance Advisory Council* (Mar. 10, 2008) at 12.

[79] IRS, Request for Quotation, Request No. TIRNO–05–Q–00187, at 22 (¶A.4.5). Taxpayer accounts will be automatically recalled after 12 months unless the account condition warrants continued work efforts by the Contractor assigned the case. Conditions that would warrant an extension of the placement period may include acceptable payment within 60 calendar days prior to recall date or approval from the Contracting Officer's Technical Representative (COTR). The IRS can request the return of a case at any time upon notice to the PCA.

[80] IRS, *Filing and Payment Compliance Advisory Council* (Mar. 10, 2008) at 12.

To Evaluate the Cost Effectiveness of the PDC Program, an "Apples-to-Apples" Comparison Between IRS Employees and PCA Employees Is Needed

As I have recommended in my reports to Congress, to determine the true efficiency and effectiveness of PCAs to the IRS collection function, I believe the IRS should design and implement a true apples-to-apples comparison of IRS and PCA collection.[81] The version of the IRS fiscal year 2008 funding bill reported by this Committee last year directed the IRS to conduct a test to make such a comparison.[82] Although this mandate was not contained in the final funding legislation, the IRS has taken steps toward implementing an apples-to-apples test. In January of 2008, the IRS created a team, which included TAS, to design such a test. The test would use IRS employees with similar skill sets as the PCA employees and limit IRS enforcement powers so their authority to take action on a case would mirror that of the PCAs, thereby creating an apples-to-apples comparison. In addition, it would create an entry-level bridge position for IRS employees who would like to obtain collection experience. These employees could work these easy cases that only require a phone call or could help locate taxpayers. This would be an opportunity for the IRS to train new collection employees and address the IRS's challenge to fill behind an aging workforce. Now that the test has been designed, it is time to put it into action so the IRS can honestly evaluate who can do this work better.

The IRS Should Reassess Its Approach to e-filing to Ensure That the Needs of All Taxpayers Are Addressed and that All Taxpayers May Prepare Their Returns and File Directly with the IRS Without Charge

While the IRS has made impressive progress in increasing the rate of electronic filing, it is still far from reaching the congressionally mandated goal of 80 percent.[83] During the 2007 filing season, almost 57 percent of all individual returns were filed electronically.[84] As the tax administrator, the IRS has the authority to determine the policies and criteria that entities must meet to participate in the e-file program. In important respects, however, it appears that the IRS has historically relinquished control of the electronic filing program to private industry and faces difficulty in reasserting ownership of the program. Considering the significant benefits e-filing affords to both the IRS and taxpayers, we are pleased that the IRS is currently evaluating its role in the e-file program in order to increase the rate of e-file and to properly align its policies and procedures to meet the best interests of taxpayers and the agency itself. We encourage the IRS to consult with the Office of the Taxpayer Advocate on this important matter, and we look forward to lending support in any manner possible.

The IRS has an incentive to increase the rate of electronic filing to the highest level possible. Electronic filing of tax returns brings benefits to both taxpayers and the IRS.[85] From a taxpayer perspective, e-filing improves accuracy by eliminating the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before returns are accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which permits the IRS to shift resources to other areas), allows the IRS to capture return data electronically, and enables the IRS to process and review returns more quickly.[86]

Nearly one-third of all individual returns processed by the IRS through October 2007—or 43 million returns—were prepared using software yet mailed rather than submitted electronically.[87] These taxpayers could have e-filed their returns once they were prepared using computer software, but for some reason, the taxpayers chose to file paper returns. If the IRS successfully converts a significant portion of these taxpayers to electronic filing, it would approach, and perhaps surpass, the 80 percent e-filing goal.

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[81] *See* National Taxpayer Advocate 2007 Annual Report to Congress 416–418, and National Taxpayer Advocate 2006 Annual Report to Congress 34–61.

[82] Financial Services and General Government Appropriations Act, 2008, H.R. 2829, 110th Cong. § 113 (as reported by S. Comm. on Appropriations, July 13, 2007).

[83] The IRS Restructuring and Reform Act of 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105–206, § 2001(a)(2), 112 Stat. 685 (1998). The 80 percent e-filing goal was not achieved by 2007. However, we believe Congress should reiterate its commitment to requiring the IRS increase the e-filing rate as quickly as possible.

[84] IRS News Release, IRS E-File Opens for 2008 Filing Season for Most Taxpayers, IR–2008–5 (Jan. 10, 2008).

[85] *See* S. Rep. No. 105–174, at 39–40 (1998).

[86] *See* IRS Fact Sheet, *2008 IRS E-File*, FS–2008–4 (Jan. 2008).

[87] IRS Tax Year 2006 Taxpayer Usage Study (through Oct. 26, 2007).

I have advocated for years for the IRS to place a basic, fill-in template on its website to permit taxpayers to self-prepare their tax returns and file directly with the IRS for free.[88] There is no reason why taxpayers should be required to pay transaction fees to file their returns electronically. A free template and direct filing portal would address some taxpayers' cost and security concerns and would result in a greater number of e-filed tax returns. For those taxpayers who are comfortable preparing their returns without assistance, the Government should provide the means for them to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they would remain free to purchase one.

During a visit to the Australian Taxation Office (ATO) last month, I had the opportunity to learn first-hand about Australia's e-file program. The ATO built e-tax, a direct filing program, completely in-house and officially launched the program in 1999. The resulting e-file (e-tax) rates are impressive.[89] For the 2005–2006 tax period, approximately 49 percent of all individuals who self-prepared filed their returns through e-tax, while only 7.5 percent of U.S. taxpayers who self-prepared their returns used Free File for tax year 2006 (and only 2.9 percent of all individual income tax returns filed in tax year 2006 were prepared using Free File).[90] Further, only tax agents (the Australian equivalent to tax return preparers) use commercial software to prepare and file returns.[91] It is our understanding that the IRS is currently evaluating the Australian taxation system. We hope the IRS can apply lessons learned from Australia's experience to our own e-file program, especially with regard to ATO's direct filing program, e-tax.

Recent, highly publicized phishing schemes confirm the need for the IRS to develop a free fill-in template and direct filing portal. During the 2007 filing season, for example, an Internet tax scam lured taxpayers into entering confidential tax return information on sites masquerading as Free File sites, and these taxpayers became victims of identity theft.[92] It is understandable that some potential Free File users fall victim to scams, especially when taxpayers wishing to prepare their returns pursuant to an IRS sanctioned program visit the official IRS website only to be directed to one of 19 potentially unfamiliar commercial websites. All taxpayers should have the option to prepare and file their Federal income tax returns on the IRS's own website.[93] Although Free File is accessible through the official IRS website, not all taxpayers are eligible to use the program. Approximately 30 percent of individual taxpayers—which amounts to more than 40 million taxpayers—are in-

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[88] *See, e.g.*, National Taxpayer Advocate 2004 Annual Report to Congress 471–477. We have proposed that the IRS create an electronic tax return that is analogous to the paper environment, but that also incorporates the benefits of electronic technology. Specifically, the return should be fill-in, with math checking and number-transfer capability. The fill-in return should link to line-by-line IRS instructions for each form, and where the IRS instructions reference a publication, there should be active links to specific sections of the forms. Where the instructions or publications have worksheets embedded in them, these worksheets should be fill-in, with math-checking and number-transfer capability. These capabilities are important, since they will substantially reduce the number of "math error" notices the IRS must issue each year.

[89] Unlike Free File, e-tax is available to taxpayers at all income levels. For information on e-tax, see http://www.ato.gov.au/corporate/content.asp?doc=/content/83847.htm&pc=001/001/001/005&mnu=&mfp=&st=&cy=1 (last visited April 7, 2008).

[90] Australian Taxation Office, Taxation Statistics 2005–06, available at http://www.ato.gov.au/content/downloads/00117625__2006CH2PER.pdf (last visited April 7, 2008); E-Gov, IRS Free File Performance Measures—Summary View, available at http://www.whitehouse.gov/omb/egov/c-7-3-irs.html (last visited April 7, 2008). Specifically, 1,521,780 individual self-preparers filed through Australia's e-tax program in tax year 2005/2006 out of a total of 3,132,230 self-preparers. The remaining 8,378,729 individual taxpayers used tax agents (return preparers). In the United States, 3.9 million individual taxpayers self-prepared for tax year 2006 on Free File out of 49 million total self-preparers. Approximately 135 million U.S. individual returns were filed for tax year 2006. IRS Document 6149, *Calendar Year Return Projections by State, CY 2007–2014* (Rev. 12.2007), Table 1.

[91] Tax agents are regulated by the statutorily created Tax Agent Boards located in every state. For more information on the relationship between tax agents and tax administration in Australia, see http://www.ato.gov.au/corporate/content.asp?doc=/content/66215.htm (last visited March 27, 2008).

[92] *See* IRS News Release, *Late Tax Scam Discovered; Free File Users Reminded to Use IRS.gov*, IR–2007–87 (April 13, 2007). The IRS is also aware of several phishing schemes during the 2008 filing season. *See* IRS News Release, *IRS Warns of New E-Mail and Telephone Scams Using the IRS Name; Advance Payment Scams Starting*, IR–2008–11 (Jan. 30, 2008).

[93] Congress contemplated the IRS developing a basic electronic template in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 685 (1998). The RRA 98 conference report states that "the conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet." H.R. Rep. No. 105–599, at 235 (1998) (Conf. Rep.).

eligible for IRS Free File.[94] Moreover, the IRS exerts little control over the content of each Free File program. As a consequence, each of the programs has its own eligibility requirements, capabilities and limitations, and the complexity is confusing to taxpayers.

Despite the IRS's best efforts, some paper filers will refuse to convert to e-file. For those cases, the IRS should develop 2-D bar code technology, which would provide taxpayers and the IRS with many of the same benefits as electronic filing.[95] It is my understanding that the IRS has already incorporated this technology into other functions.

Pursuant to an Appropriations directive, the IRS Office of Electronic Tax Administration and Refundable Credits (ETA) is developing a comprehensive strategic plan to meet the 80 percent e-file goal.[96] ETA has commissioned MITRE to conduct the Advancing E-File Study, and we are pleased that the study will determine or review the following items:

—The characteristics of paper and e-filers as well as potential barriers to e-file;
—The current third-party model of tax administration and current trends in State and foreign governments; and
—Potential strategies to increase the rate of e-file or any other means to receive return information electronically. This will entail a review of direct filing with the IRS, 2-D bar coding, and Telefile.[97]

I believe this study represents an important first step in the Government's fulfilling its core responsibility to taxpayers in a secure and straightforward fashion, without competing with the private sector. The Appropriations directive states that this strategic plan should be developed in consultation with me and other stakeholders, and I look forward to continuing to work with the IRS on this study.

Finally, I believe that the IRS should take a more proactive role in the electronic filing arena by setting the policies and standards for participation in the IRS e-file program. Such policies and procedures should align with the needs of both taxpayers and tax administration. All high quality return preparation and filing products should have equal access to the market, reflect the latest tax law changes, and be compatible with filing season peaks in demand as well as IRS's computer and processing needs. Moreover, all programs should meet IRS established minimum standards for data and identity security, and these standards should apply to both for-profit and free tax preparation offerings.[98] Unless the IRS takes corrective action, the IRS remains in a reactive position at the whim of private industry and is forced to devote scarce resources to address the downstream consequences of potentially avoidable problems. We are encouraged that the IRS is currently evaluating its role in the e-file program as part of the Advancing E-File Study and look forward to lending support to the study as well as to receiving periodic briefings of research findings as the study progresses.

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[94] Taxpayers must have adjusted gross income of $54,000 or less to be eligible. *See* IRS Fact Sheet, *2008 IRS E-File*, FS–2008–4 (Jan. 2008); Free Online Electronic Tax Filing Agreement Amendment (2005), available at http://www.irs.gov/pub/irs-efile/free_file_agreement.pdf (last visited on April 7, 2008). Ironically, some members of the Free File Alliance provided free services to 100 percent of taxpayers under the initial term of the Free File Agreement and wanted to continue to do so, but the Treasury Department agreed with the Free File Alliance to place a cap on the number of taxpayers who would qualify for free tax preparation and filing services. As a consequence, Free File members are now *restricted* in the number of taxpayers to whom they may offer their services.

[95] To utilize 2-D bar code technology, a taxpayer or preparer uses software to complete the return. Once printed, the return has a horizontal and vertical bar code containing tax return information. The IRS scans the return, captures the data, decodes it, and processes the return as if it had been sent electronically.

[96] Staff of H. Comm. on Appropriations, 110th Cong., H.R. 2764, Consolidated Appropriations Act, 2008, Pub. L. 110–161, Explanatory Statement at 871 (Comm. Print 2007); Staff of H. Comm. on Appropriations, 110th Cong., Financial Services and Government Appropriations Bill, 2008, at 28 (Comm. Print July 2007). Although the deadline for submission of the study was March 1, 2008, the IRS Office of Electronic Tax Administration and Refundable Credits has faced considerable challenges during the current filing season, and it is planning to complete the study later this year.

[97] Information Provided by Electronic Tax Administration (Jan. 30, 2008); Diane Freda, *IRS to Study Direct Filing Portal, 2-D Bar Coding to Boost E-Filing*, BNA Daily Tax Report (Jan. 29, 2008); MITRE IRS FFRDC, Center for Enterprise Modernization, IRS Advancing E-File Study: Draft Overview of Findings to Date (Jan. 31, 2008) (on file with the Office of the Taxpayer Advocate).

[98] At the time of this writing, it is not clear how many of the programs listed on the IRS e-file partner webpage would meet IRS-developed data or identity security specifications.

Taxpayer Advocate Service Case Receipts Have Risen by 47 Percent Since Fiscal Year 2004 While the Number of Case Advocates Available To Work Taxpayer Cases Has Declined by 13 Percent

I will close with a brief report on my own organization, the Taxpayer Advocate Service (TAS), and its role in identifying and mitigating the downstream consequences of IRS actions and programs, and improving taxpayers' attitudes toward the tax system. Since I became the National Taxpayer Advocate in 2001, I am pleased to say that TAS has grown up as an organization and substantially improved its ability to assist taxpayers. In fiscal year 2001, our quality measures showed a performance level of 71.6 percent. In fiscal year 2007, TAS's talented and dedicated employees managed to achieve a quality rating of 90.5 percent. The performance of TAS employees since fiscal year 2004 has been particularly commendable—TAS case receipts rose an overwhelming 47 percent from fiscal year 2004 to fiscal year 2007,[99] while the number of case advocates available to work those cases declined by 13 percent over the same period. Yet we have managed to handle this increased workload while maintaining consistent case quality over these 3 years.

The increase in TAS cases is not surprising. The IRS has substantially increased the number of its compliance actions in recent years,[100] and about 65 percent of TAS's cases are classified as "compliance" related.[101] Increasing the number of compliance cases inevitably produces a corresponding increase in TAS cases. Thus, the greater IRS emphasis on enforcement has resulted in a greater need for TAS services. Economic downturns also contribute to increases in TAS inventory, as taxpayers who lose their jobs and become unable to pay their tax bills get into trouble with the IRS and seek assistance.[102]

TAS is able to assist most taxpayers who seek our help. Overall, TAS was able to obtain full relief for the taxpayer in 69 percent of the cases we closed in fiscal year 2007 and partial relief in an additional 4 percent of our cases.

TAS Customer Satisfaction surveys provide some evidence that the quality and nature of taxpayer service has an impact on taxpayer attitudes toward the tax system. When a taxpayer brings an eligible case to TAS, he is assigned a case advocate who works with him throughout the pendency of the case. Taxpayers have a toll-free number direct to that case advocate, and each TAS office has a toll-free fax number. TAS employees are required to spot and address all related issues and to educate the taxpayer about how to avoid the problem from occurring again, if possible. This level and quality of service drives TAS's high taxpayer satisfaction scores, as evidenced by the results for the last 2 years. In fiscal year 2006 and fiscal year 2007, the percentage score for overall satisfaction of the taxpayers who came to TAS was 85 percent and 83 percent, respectively. Equally important, 50 percent of taxpayers stated that they felt better about the IRS as a whole after coming to TAS. Even among taxpayers who did not obtain the result they sought, an impressive 34 percent reported that they had a more positive opinion of the IRS because of their experience with TAS.[103]

However, I am concerned that with the increasing volume, complexity, and urgency of TAS's caseload, the cycle time for our cases has begun to increase. Closed case cycle time was 71.1 days in fiscal year 2004 but has risen to 80.6 days in fiscal year 2008.[104] These results are hardly surprising. If you increase the workload of a customer service organization by 47 percent and reduce the number of employees available to assist customers by 13 percent, you are essentially increasing the average workload of each employee by nearly 70 percent. And because TAS generally assists taxpayers only where they face an imminent economic burden because of an

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[99] In fiscal year 2007, TAS received a total of 247,839 cases. In fiscal year 2004, TAS received a total of 168,856 cases.

[100] On the Examination side, the number of individual return closures increased by 37 percent and the number of business return closures increased by 102 percent from fiscal year 2004 to fiscal year 2007. On the Collection side, the number of levies increased by 85 percent, the number of liens increased by 28 percent, and the number of seizures increased by 54 percent over the same period. See Internal Revenue Service, fiscal year 2007 Enforcement and Services Results (Jan. 17, 2008) (accompanying fiscal year 2007 Enforcement and Services Tables), available at http://www.irs.gov/pub/irs-news/irs_enforcement_and_service_tables_fy_2007.pdf.

[101] In fiscal year 2007, TAS classified 160,131 case receipts as compliance-related and 87,708 as service-related, for a total of 247,839 case receipts.

[102] TAS received 86,261 economic burden case receipts in fiscal year 2007 compared with 34,653 in fiscal year 2004—a 149 percent increase.

[103] For fiscal year 2006, the Gallup Organization collected the customer satisfaction data for the Taxpayer Advocate Service. In fiscal year 2007, TAS began using a new vendor, Macro International, to conduct its surveys.

[104] Fiscal Year 2008 data reflects case closures from October 1, 2007 through March 31, 2008 (six months).

IRS collection action or where normal IRS procedures have failed, TAS does not have much flexibility to turn away cases. Indeed, TAS expects to receive more than 250,000 cases in fiscal year 2008, and our case inventory continues to rise. If the balance between TAS staffing and the number of cases we handle does not improve, I am concerned that TAS is in jeopardy of becoming part of the IRS problem rather than the advocate for the solution, as Congress intended.

Lastly, I provide a brief report on the Low Income Taxpayer Clinic (LITC) program, which is administered by my office. For fiscal year 2008, the IRS's Taxpayer Services appropriation included $9 million for LITC grants. This appropriation represented an increase of $1 million compared with the 2007 grant cycle.[105] The LITC program currently funds 154 clinics in all 50 States, the District of Columbia, Puerto Rico, and Guam, thus meeting my goal of having at least one LITC in each State. The increased appropriation allows us to provide funding for new clinics as well as to provide increased funding for existing clinics that have expanded or plan to expand their services to underserved areas and populations. This additional funding also has enabled the LITC Program to work toward its goal of funding at least one controversy and at least one English as a Second Language (ESL) clinic in every State. The LITC Program Office, in conjunction with TAS Research, has identified locations where there are significant populations of low income and ESL taxpayers who are not currently served by a clinic. Recently, we announced a supplemental grant period to solicit qualified organizations willing to address the needs of these identified areas.[106]

Conclusion

Compared to the IRS of 10 years ago, the IRS of today is a more responsive and effective organization. On the customer service side, the IRS Restructuring and Reform Act of 1998 and the IRS response have brought about fairly dramatic improvements, and the Taxpayer Assistance Blueprint, created in response to an Appropriations directive, provides a useful roadmap to maintain and improve the delivery of taxpayer services. On the enforcement side, the IRS has been ramping up its enforcement of the tax laws, particularly with regard to corporate tax shelters and high-income individuals, and the results have generally been positive.

But the IRS can, and should, do better. To increase voluntary compliance, the IRS should incorporate an ongoing taxpayer-centric assessment of taxpayer service needs into its strategic plans. It should consider whether it can meet taxpayer service needs adequately when it devotes only 6 percent of its budget to taxpayer assistance and education. It should conduct research (including applied research) into the causes of noncompliance and apply the resulting knowledge to IRS enforcement strategies, including those pertaining to the cash economy. Finally, the IRS must have sufficient resources to move forward with its technological improvements, which are critical to its ability to improve both its Taxpayer Services and Enforcement functions.

PRIVATE DEBT COLLECTION

Senator DURBIN. What a loser this private debt collection is. I mean, it just seems like we are stuck on this. Not to say anything negative about our colleagues, but my guess is that it is just a nice, little business with a bunch of employees in several places in America that the Senator and Congressmen want to keep open, but it sounds like it is a bad deal. This is privatization that is costing us more than if we used the public employee. Is that your conclusion?

Ms. OLSON. Well, I think that it originated in a concern that there was a pool of taxpayers that the IRS was not currently touching and that we were not going to get additional appropriations to hire employees to touch those taxpayers. And what has turned out is that, first, that pool of cases, the ones that are easy to work, do not exist. We are running out of those cases and we are reaching

[105] Although appropriations are made on a fiscal-year basis, grants for the LITC program are awarded on a calendar-year basis (which we refer to as the "grant cycle").

[106] Low Income Taxpayer Clinic Grant Program; Availability of 2008 Supplemental Grant Application Period, 73 Fed. Reg. 15,841–42 (Mar. 25, 2008).

into cases that the IRS is actually scheduled to work, and we are stretching the bounds of what PCAs can do efficiently.

The second thing we have found is what I highlighted in my testimony, that a lot of these cases, if the IRS sent a letter—we get a return that a lot of these cases have just been sitting there——

Senator DURBIN. You said 46 percent.

Ms. OLSON. For a 41-cent stamp, we would get the taxpayer going, oh, they are back on the scene. We need to respond to them instead of our other creditors.

Senator DURBIN. Of course, if the private debt collector gets in, they get what? Twenty-five cents on $1?

Ms. OLSON. Well, up to 25 cents on $1? Yes, correct.

Senator DURBIN. So that seems like a loser.

Mr. George, about this brain drain, do you know what the IRS is doing to use student loan forgiveness to either recruit or retain talented people?

Mr. GEORGE. Actually I do not, Mr. Chairman. Allow us to get back to you on that.

Senator DURBIN. Would you?

Mr. GEORGE. But if I may, though, could I briefly address the private debt collection issue?

Senator DURBIN. Sure.

Mr. GEORGE. Because TIGTA recently conducted an audit and there are a couple of facts that I would like to share with this subcommittee for your appreciation.

As of February 23 of this year, the total cases assigned to the private debt collection agencies are approximately 98,000 with the dollars assigned of just under $900 million. The actual payments received as a result of this program are $46.19 million. Out of this, the commissions paid to the private debt collectors has been just over $7 million. The number of accounts paid. Again, out of approximately 98,000, the total number of accounts fully paid is just over 12,000. The number of accounts entering into installment agreements is just over 5,000, and the number of accounts referred to, as we call them, taxpayer account services is just over 1,300.

We really do not know whether or not a simple letter would achieve these results. We have not done the research to give you a definitive answer in that regard. But Senator Brownback may recall that when he was on the Government Reform Subcommittee, chaired by Congressman Stephen Horn, over 10 years ago, we worked on this very issue. Back then the program, the pilot that was established, was an abject failure. No one would disagree with that point. Here we just simply do not know whether the startup costs are those that the private sector would simply assume are a part of doing business as the startup costs.

So the bottom line is I am saying I want to make sure that this tax gap is addressed somehow and if turning to a project such as a private debt collection would help address it——

Senator DURBIN. It sounds objective and valid, but it is not working. How long have we been trying this now?

Ms. OLSON. The program started in September 2006, and in fact, the way it is structured is any payments that come in the first 10 days in response to the first letter the IRS sends to the taxpayer saying, hello, we are back, we are going to send your case out to

the private debt collectors if you do not respond to us, are non-commissionable payments. And we do have those numbers. In 2007, out of the $32 million—is that how much we collected? And $31 million in 2007. About $5 million came in the first 10 days.

So you can see it is about 19 percent of the collections were in response to the IRS letter, and I maintain that if we sent a letter saying, hello, we are back and we could levy on your bank account, on your pay stub, all the things that we could do, we would get a response.

Senator DURBIN. I am going to go over time here.

Senator BROWNBACK. I will not tax you.

Senator DURBIN. Thanks. No penalties, no interest.

BUSINESS SYSTEMS MODERNIZATION

Mr. Cherecwich, my experience has been that the Federal Government is not very darned good when it comes to business modernization systems. And I have some personal experience since 9/11 trying to get the FBI to have an updated computer system. I cannot tell you how much money we have wasted in that effort and still are not where we ought to be.

There are similar efforts that have been made in trying to verify visas coming in and out of this country. For more than 10 years, we have failed to come up with what appears to be a pretty simple task.

So what kind of confidence do you have if more money is funneled into the IRS for business modernization systems and technology that it is going to be well spent?

Mr. CHERECWICH. A couple of responses to that, Senator. Typically with high-tech projects, you have a little bit of risk going into them, and delays and failure to meet schedules are to be expected. Any business that tries to install a massive computer system like we are talking about, a massive information system, will expect to have hiccups along the road. What happens in business when you get a hiccup along the road is not that you cut the funding because they are bad boys. You turn around and you provide the support in the manner in which you feel that they can deal with that.

Now, how do I feel comfortable that they can deal with that? The IRS in the last few years has developed something they call a modernization and visions strategy for their computer systems, their information structures. And this modernization and visions strategy is a tool in which projects can be prioritized and the appropriate management assigned to make them work. It is an overall program that gives me a great deal of comfort that the IRS is on a proper path to properly manage this.

Where we will run into difficulty is this ramped-down stuff where we start losing all the skilled people. We need to have good, steady, level funding and keep moving forward.

Senator DURBIN. I am going to ask my ranking member a favor here. I have to take a phone call, and if he would be kind enough to ask questions and recess the subcommittee meeting. I want to personally thank the panel and others who have been here today to help us.

Senator Brownback.

Senator BROWNBACK [presiding]. Thank you very much.

All those in favor of a flat tax?

I have got to wait until he gets out of the room.

TAX SIMPLIFICATION

I want to look at tax complexity. You guys are very familiar with this Code. I think the difficulties of enforcement are interesting.

I presume all of you would agree with me that if Congress provided a simpler Code, that there would be more compliance with the tax system.

Mr. CHERECWICH. It is hard to argue with that one.

Mr. GEORGE. I agree, Senator Brownback.

Senator BROWNBACK. Have you studied or looked at other countries that have simplified codes—other industrialized countries that have a similar system and know of compliance rates? Nina?

Ms. OLSON. Well, I think that some of them are—although the IRS might not like this heard—comparable to us. Some of them have divided their tax systems between a modest income tax and then a value-added tax or a goods and services tax.

I think that some of the directions talking about a return-free system, some of the systems like Sweden where they have so much information on their individuals, that they have a very high compliance rate, but they know more about their citizens——

Senator BROWNBACK. Yes. Well, our folks do not really go for that.

Ms. OLSON [continuing]. Than United States people would want.

Senator BROWNBACK. But are there other industrialized countries that have simplified systems that are not thoroughly penetrated into a person's personal information?

Ms. OLSON. I was just in Australia this past month for a tax conference, and they have a system that has income tax, has a pay as you earn essentially system, so that many people just like the United Kingdom do not have to file taxes because the taxes are paid by the employer and you pay what you pay each paycheck and you do not do a return reconciling. You only file a return when you have sole proprietorship income or capital gains, you know, transactions that the tax system would not know about. And then the rest of the tax is made up by either a goods and services or a value-added tax, which is paid along the way and is invisible to the individual taxpayer at least.

Senator BROWNBACK. What would you like to see us do to simplify the system?

Obviously, up here in Congress we use the Tax Code to try to manipulate the economy, to try to stimulate the economy, to try to get people to do certain things. And each attempt adds a layer of complexity, and we are all guilty of it. Every lobbyist in town is hired by somebody to do something in this Tax Code, and they are very good. So you have got an incredibly complex Tax Code.

But what would you like to see us do? What should we do on tax simplification?

Ms. OLSON. Well, let me hedge my comments by saying I do not do tax policy. I look at this from the taxpayer's perspective in terms of being asked to comply with the laws and the difficulty there. And so I will not go into whether it needs to be a flat tax or what kind of tax. But whatever tax system we have it has to be intuitive

to the basic taxpayer and not impose arcane rules like the alternative minimum tax that confuses people.

I think that the President's reform panel made some really interesting proposals, and I would like to see some of them revisited.

I think that, as well, we do need to look around the world and see what other industrial nations are doing and what the differences are with their population and our population. We have to keep the taxpayer's perspective in mind and say what is it that taxpayers can handle so that we do not set them up for problems.

Senator BROWNBACK. I have studied some on the flat tax systems in different countries, and the countries I have gone to are generally second world countries. But they substantially lowered their rate. They simplified their system. They increased Government revenue substantially in those places and they increased compliance. Currently, with high rates and complexity, a lot of people just said, I am out of here. I am going to figure a way around you guys, and did. But if it got down to a rate that was fairly simple, a lot more people will say, well, rather than trying to skip around this, I will pay it. That is that intuitive piece, I think, of what you are saying.

Ms. OLSON. Yes. Well, and I think also that goes to something else we have been recommending which is that IRS do more research into the reasons that taxpayers do not comply because once you learn that, you can incorporate that into not only just how do you do your outreach and your education and your enforcement initiatives, but also into your system design. If you know what causes taxpayers to not comply, whether it is attitude or the sheer complexity of the laws, they get confused, that informs how your system should look.

Senator BROWNBACK. Do we know the answer to that, Mr. George?

Mr. GEORGE. Well, I have to, at the outset, say, Senator Brownback that, as Nina indicated, tax policy is not my bailiwick and actually under directives within the Department, I am not in a position to advocate a particular policy.

That stated, there is no question that if there were a simplified tax system, more people would easily or more readily comply with their requirements. For example, I note that if the legislation that is before Congress helping to determine the cost basis of stocks were enacted, that would most definitely, I think, help in terms of the overall compliance with people acknowledging what they paid and what they owe after stock transactions. I actually had an opportunity to raise this issue with Jim Cramer of CNBC and he readily acknowledged that that would be a very helpful device and that it would not be too burdensome on the financial industry.

Senator BROWNBACK. It would seem like all you guys could help us quite a bit if, as we are proposing tax changes, which happen every year in the Congress, you had some sort of complexity index or rating of what this is going to do on making the Tax Code more complex. Our focus is the policy initiative we are trying to hit with the money we have. That is the whole game. We want to go green and we have got this pool of money. So how do we get this policy into that amount of money? But we never really look at the complexity issue of what it is going to do to the complexity of the code and its impact.

It would be a helpful exercise actually, particularly because I think right now what people are most fed up with is the complexity of the Code. I would like to see the rates lower. I think most people would like to see the rates lower. But what really drives them nuts is how complex this thing is.

Mr. CHERECWICH. Senator, our Board conducts an annual attitude survey among taxpayers, which I referred to earlier. Among the findings of that survey is most Americans think it is inappropriate to try to cheat on their taxes. They think it is appropriate to pay the taxes as required.

Given the complexity of the Tax Code, we feel that it is very important to balance the combination of services with enforcement. We have a tax gap and we cannot audit our way out of the tax gap. We have to have this balance with services and enforcement. And that is the reason why our recommended budget for fiscal year 2009 has that balance in recognition of the complexity that you talk about.

Senator BROWNBACK. I think you also note in there if it was not as complex, you would not have quite as big a tax gap. That is a feature of it as well. That is our role here in Congress, and I think we need to do a lot better on that.

Thank you all very much for being here.

ADDITIONAL COMMITTEE QUESTIONS

The record will remain open for a period of 1 week for people to be able to submit additional questions or for panelists to submit statements into the record.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR MARY L. LANDRIEU

Question. Last year, I sent a letter to Acting Commissioner Stiff, suggesting several ways to alleviate some of the financial burdens on individuals who are being taxed on these grants. In Commissioner Stiff's December 27, 2007 letter to me, she responded that all but one of my suggestions required a legislative fix. The one suggestion she did not address—providing families more time to pay back any tax attributable to their grant—would have provided short term relief and would have allowed us more time to craft a legislative solution to the problem.

Why didn't Commissioner Stiff address this solution?

Answer. I understand that then-Acting Commissioner Stiff intended the response to indicate the mitigation you requested, extending the time to pay back tax attributable to a Road Home grant, requires legislative action. We apologize for not being clearer in this regard.

Question. Could the IRS have allowed for an extension of time?

Answer. No, there is no legal basis to extend the time period for affected taxpayers to pay the tax due. Legislation would be required in order to provide additional time to pay the tax due in this case, either by extending the payment date or providing for a payment of tax over a number of years.

Question. What was the basis for concluding that the IRS could not provide additional time for hurricane victims to pay back any tax attributable to a Road Home grant?

Answer. The IRS does not have the discretion applicable to provide taxpayers with an extension of time to pay taxes due.

Question. Are there other administrative steps that the IRS can implement to mitigate the effects of its decision to tax Road Home grants?

Answer. Because, as discussed above, our administrative flexibility is limited under the law, the IRS has focused on providing information to keep taxpayers well-informed on this issue. Representatives from the IRS met with tax professionals and

others to provide tax assistance on Road Home grant issues (among other tax issues relating to the hurricane). The IRS continues to keep an open dialogue with local tax professionals to identify and address emerging filing issues, including issues involving Louisiana Recovery Authority (LRA) Grants and the effect of the taxpayer reporting a casualty loss in a prior tax year. The IRS website has a page dedicated to providing information on disaster relief, which includes detailed responses to frequently asked questions for hurricane victims concerning the tax implications of Road Home grants, including the tax-benefit rule.

QUESTIONS SUBMITTED BY SENATOR WAYNE ALLARD

Question. Can you please provide me with an accurate and detailed account outlining where the IRS audit process involving conservation easements currently stands in Colorado?

Answer. The status of the audit process is as follows:

—We have issued 183 private offer letters. These private letter offers are similar to settlement proposals. The letters address over 400 tax years and over 103 easements. They concern over $38,900,000 in claimed easement donation value.

—Of the 183 offer letters, 64 (35 percent) have been accepted, 91 (50 percent) have been rejected, and 28 (15 percent) are pending.

—We expect to send a small number of additional offer letters within the next several weeks.

—Audits are continuing for 316 taxpayers, 489 tax years, and 159 easements.

—Audits have concluded for 356 taxpayers, 667 tax years, and 168 easements.

Question. Does the IRS have any intention of refocusing its investigation off of legitimate easements and focus solely on those who have been targeted by the state?

Answer. The IRS strives to avoid focusing its investigations on legitimate easements. Our efforts have focused on two approaches. First, we attempted to resolve through our settlement offer program those cases in which the sole issue was valuation of the easement. Although this approach resolved many cases, we will need to do further work with respect to those taxpayers who declined to accept the settlement offer. Second, we have been investigating some of the organizations that have been targeted by the state of Colorado as promoters of questionable or abusive easements. We intend to pursue our work with respect to these cases as we complete our work on conservation easements in Colorado and elsewhere across the United States.

Question. In mid-November, the IRS began making settlement offers to a significant number of conservation easement donors under audit in Colorado. According to the IRS, the settlements were only offered in those cases where the sole issue between the donor and the IRS is valuation.

The offers generally fell into a "bucket" where the IRS stated only 30 percent, 60 percent, or 75 percent of the original value of the charitable donation was allowed.

What were the criteria the IRS used to place different taxpayers into these various "buckets"? Did the IRS indicate in writing to the donor how or why the IRS arrived at their decision? If not, why?

Answer. The IRS established the three separate categories after reviewing factors that affected the strength of the taxpayers' appraisals and other substantiation of the deductions claimed, with the highest allowance percentage being provided to those taxpayers the IRS believed had the strongest cases, taking into account the hazards of litigation. A 30 percent allowance offer was made to those taxpayers that had subdivided their properties into small parcels, such as 35 acre parcels, in connection with making a contribution of an easement.

The primary difference between the 60 percent and 75 percent categories was the extent of the taxpayer's appraisal process; 75 percent was offered to those identified as having undergone an appraisal process that was identical or similar to Colorado's "Great Outdoors Colorado" (GOCO) process; and 60 percent was offered to all other taxpayers. GOCO is a state program intended to encourage conservation and preservation, including through conservation easements.

We attached as Appendix A a copy of the standard form of letter that was sent to the taxpayers, as well as one of its attachments—a letter from the state of Colorado concerning the resolution of state income tax liability. The standard letter invites taxpayers to contact the IRS with any questions they may have. Many taxpayers who received this letter have done so, and have discussed their offers and the reasons for them with Revenue Agents and Engineers.

Question. Since the IRS investigations began into the 2003 easements how much money has the IRS recuperated and how much taxpayer money has been spent on the blanket audit of conservation easements in Colorado?

Answer. Our information systems do not track costs in this fashion. To date in Colorado we have assessed $6.9 million in tax, penalties, and interest in these cases.

We respectfully note that decisions on administering the tax laws generally are not guided exclusively by a cost-benefit approach as contemplated by the question. Other considerations, including requirements of the tax law, the deterrent effect on taxpayers, and the interests of justice, must be taken into account.

Question. Wouldn't the IRS be more successful in recuperating tax dollars if it investigated the same fraud the state uncovered rather than auditing good easements that have been shown to meet rigorous state and national standards?

Answer. The IRS commenced this examination program because of problems reported and discovered in conservation easement donations generally, but initially focused on Colorado after the State of Colorado expressed its concerns regarding valuation and other issues involving donations made in Colorado. The State initiated its actions after our work elsewhere had begun. We have and will continue to work collaboratively with the State of Colorado and will focus on what we believe are the more egregious cases.

Question. How much money does the IRS expect to spend defending its settlement offers in court? Do you find this to be a good way of using taxpayer's dollars?

Answer. No reliable estimate of such costs is possible until we know better the number of cases involved. However, as we choose how to audit and resolve cases, we always take into account limited resources and long-term strategies. We experience such choices in virtually every examination initiative.

Question. Does the IRS have appraisers or other professionals that are experts in conservation easements? If not, why?

Answer. Yes, the IRS does have a number of appraisers and other specialists who are experts in valuing various forms of property, and who have valued conservation easements for federal income tax purposes.

Question. Has the IRS used the experts in conservation easement valuation or tax law that have offered their expertise? If not, why?

Answer. Yes, and we will be using more. The IRS is currently working to hire additional experts to work Colorado cases, including cases involving potentially abusive promotions of easements.

Question. The longer these cases remain pending, the more impact they can have on land conservation in Colorado. When does the IRS expect to conclude their investigation?

Answer. The IRS understands the need to be expeditious in attempting to resolve these cases. The IRS has already completed examination work in Colorado easement cases involving 168 easements. Cases involving 159 easements remain open at this time. The IRS continues to work toward completing its examinations involving Colorado easements, and we recently dedicated additional resources to complete them as quickly as possible. Although the IRS expects to conclude many of its examinations of the existing open Colorado conservation easement cases by December 2008, we expect that the balance of the examinations work will not be completed until as late as June 2009. This timeframe does not include the time required for cases to work their way through the Appeals and litigation processes.

APPENDIX A

Internal Revenue Service (IRS Address) Date: {Taxpayer name} {Address }	Department of the Treasury Refer Reply to: Group: Person to Contact: Employee Identification Number: Contact Telephone Number:

Dear (Taxpayers name):

This letter is to inform you that Appeals has considered the federal tax implications of a group of returns reflecting charitable contributions of conservation easements in the state of Colorado. Because your conservation easement is within that group, the Internal Revenue Service proposes to resolve the issue(s) related to the conservation easement contribution claimed on your federal income tax return for XXXX(tax year) under Delegation Order 4–25, as described below. This proposed offer must be accepted within 30 days of the date of this letter.

This resolution reflects Appeals' assessment of the hazards of litigation. Appeals has concluded the settlement proposed in this letter is an equitable resolution of the issue(s). Absent atypical facts and circumstances, you (investor or investor partner) should not expect a resolution of the tax issue on terms that are more favorable

than the terms offered in this letter. If you do not accept this offer, the resolution of your case in Appeals will be based on the merits of the issues presented and may in fact be less favorable than the terms of this letter.

If you accept this offer, the Service will resolve your conservation easement on the following terms. For purposes of this settlement:

1. The government will treat the easement you donated during the year 20xx as a qualified conservation easement contribution.

2. The allowed amount of the conservation easement contribution is based upon the amount of the value of the easement originally claimed and the hazards of litigation. Please see the attached Form 4549A.

3. If you sold or transferred the Colorado state tax credit resulting from the donation of the conservation easement, the amount you received in exchange for the sale or transfer will be subject to tax as ordinary income. Please see the attached Form 4549A.

4. If the settlement results in an adjustment for a period(s) other than the period(s) listed in the first paragraph of this letter, you will file amended returns reflecting the settlement and furnish copies of same to the person named above.

5. You are liable for interest as provided by law.

You are not eligible for this settlement offer if the conservation easement in question involves:

1. An appraisal that determines the highest and best use for the property is the extraction of natural resources where such resources have not been shown to exist or to be economically feasible to extract.

2. A quid pro quo arrangement.

3. Property which was purchased or sold within 18 months of the contribution of the conservation easement.

4. A contribution made to a donee organization that either does not qualify under section 501(c) (3) of the Internal Revenue Code or is under active consideration for termination of its exempt status.

5. An appraisal from a participant or individual who was involved in the promotion or marketing of conservation easements or under investigation for inflated valuations.

6. Conservation land easement on property outside the state of Colorado.

7. The legal issue of whether the contribution is a qualified conservation contribution under section 170(h) of the Internal Revenue Code.

In addition, you are not eligible for this settlement offer if you are:

A. A party to a court proceeding (individual or as a partner in a TEFRA partnership) in which the determination of the tax treatment of the conservation easement is at issue.

B. A partner, owner, promoter, or advisor in the business of developing real estate.

C. A promoter, partner of a promoter, or employee of a promoter of a conservation easement transaction.

D. A person under criminal tax investigation. This includes a person under related criminal tax investigation by the Service or the Department of Justice, or a person who has been notified before the date of execution of the Form 906, closing agreement, that the Service or the Department of Justice intends to commence a tax related criminal investigation of that person.

If any of the above exclusions applies, you are not eligible for this settlement offer.

If you are eligible for this settlement offer and wish to resolve your Colorado conservation easement issue on the terms set forth above, you must sign and return the enclosed Forms 870–AD (triplicate original signatures) and Forms 906 (triplicate original signatures) to the person whose name is listed above within 30 days of the date of this letter.

You must thereafter cooperate with the Service to resolve your case expeditiously. In addition if the Service requests additional information, or documents necessary to effect this settlement, you must provide those documents within 20 calendar days of the request. The Service will grant an extension of the 20 day period only in exceptional circumstances and at its discretion.

The settlement is not binding until both you and the Service sign a specific matters closing agreement (Form 906) and Form 870–AD resolving the issues for all taxable years affected by this transaction in accordance with the above terms. When the Service signs the specific matters closing agreement, the one-year period of limitations on assessment will begin under section 6229(f) of the Internal Revenue Code for investor partners.

Full payment of the liabilities under this offer is expected by the date the closing agreement and Form 870–AD are returned to the Service. If you are unable to make full payment, you must submit complete financial statements (Form 433–A or Form 433–B, as appropriate) and return them to the person whose name is listed above.

If you choose not to accept this proposed settlement or you are not eligible for this settlement, development of the issue will continue. If the issue is still in dispute at completion of the examination, you may request an Appeals conference.

This settlement is solely a settlement of civil tax matters. No statement contained herein shall be deemed to be an admission by the Service. Nothing herein shall preclude the Service from asserting a position on the merits that is different from this settlement in contexts other than those concerning the civil tax liability of the taxpayer-parties whose cases are settled under this offer.

If you choose to have a representative you must authorize such representation by completing a Form 2848, Power of Attorney and Declaration of Representative. You can obtain this form from a local IRS office, through our website at www.irs.gov or by calling 1–800–829–3676.

Also, enclosed is a letter from the state of Colorado which provides instructions on resolving your state income tax liability involving this issue provided that you resolve your federal tax matter at this time.

If you have any questions, please contact the person whose name and telephone number appear at the top of this letter.

Sincerely,

Name of Person Issuing Letter
Title of Person Issuing Letter

Enclosures:
Form 906
Form 870–AD
Form 4549A
Form 433–A
Form 433–B
State of Colorado letter

STATE OF COLORADO,
TAXPAYER SERVICE DIVISION,
DEPARTMENT OF REVENUE,
DENVER, COLORADO 80261, NOVEMBER 1, 2007.

COLORADO DEPARTMENT OF REVENUE SETTLEMENT OFFER

Taxpayers who participate in the Internal Revenue Service's conservation easement donation settlement offer will also be eligible for a settlement offer from the Colorado Department of Revenue according to the terms set forth below. The IRS will advise the Colorado Department of Revenue of the identity of taxpayers who qualify for their offer as allowed through our information sharing agreement.

In order to accept the Colorado offer, the taxpayer must file an amended return for all affected tax years within 30 days of the acceptance and execution of the IRS' settlement offer. The amended return(s) will include:

—Adjustments to federal taxable income matching the federal settlement adjustments;

—Adjustment to Colorado's federal charitable contribution deduction addback to the extent applicable to the federal settlement adjustments;

—Repayment by the easement donor of 50 percent of the gross conservation easement tax credit that would have been disallowed under the federal settlement adjustments. The donor may pay this amount rather than having the transferees assessed.

Questions regarding this offer should be referred to Richard Giardini at the Colorado Department of Revenue at 303–866–3900.

RICHARD GIARDINI,
Colorado Department of Revenue, Taxpayer Service Division.

SUBCOMMITTEE RECESS

Senator BROWNBACK. The hearing is recessed.

[Whereupon, at 4:13 p.m., Wednesday, April 16, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

WEDNESDAY, APRIL 30, 2008

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:02 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin and Brownback.

CONSUMER PRODUCT SAFETY COMMISSION

STATEMENTS OF:

NANCY A. NORD, ACTING CHAIRMAN
THOMAS H. MOORE, COMMISSIONER

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. I am pleased to welcome you to this hearing today before the Financial Services and General Government Appropriations Subcommittee.

Today we will discuss the President's fiscal year 2009 budget request for the Consumer Product Safety Commission (CSPC). Testifying before us will be Acting Chairman Nancy Nord and Commissioner Thomas Moore.

THEN AND NOW

Last year, thanks to investigative reporting by the Chicago Tribune, which won a Pulitzer Prize for its work, I became concerned about toy safety issues. With the spotlight shining on some deadly toys, America became much more aware of the dangers of toys on store shelves, often ones coming from China.

At this time last year, we were reviewing the budget of an agency that had been neglected and underfunded for years. We acted together on a bipartisan basis last year to boost funding from a level of $63 million to $80 million, a dramatic increase by today's budget standards. The House and Senate both passed reauthorization bills to improve CPSC's abilities to protect the public.

So now, with the 28 percent increase in funding last year and an expected final reauthorization that will, if the Senate prevails, give the CPSC new tools, we will be able to prevent dangerous products from reaching stores, ensure faster recalls, and allow families ac-

cess to information on existing safety complaints. I think the Consumer Product Safety Commission has the potential to become an exemplary watchdog agency.

The Commission has gone from a high of 978 full-time employees in 1980 to a low of 380 employees in January of this year. Now that it is turning around, because CPSC has the funding we provided to replace the key staff it has lost over the years, I hope the Commission will swiftly hire all the needed technical experts and investigators to get the agency back to better fulfill its mission.

We discussed last year in detail the dilapidated laboratory that CPSC uses to test toys. I understand that Bob, one of the toy testers, has since retired. Bob became a very famous figure in America, as we talked about his workbench and his testing laboratory.

But soon CPSC will move to a new and improved testing laboratory. We provided funding last year to enable that timetable to be accelerated, and with funds requested in fiscal year 2009, the Commission will be able to move into the space a year earlier than expected.

FISCAL YEAR 2009 PRESIDENT'S BUDGET

While good things are being done with funding provided last year, unfortunately, the President did not join in the cheer. The President froze funding for this agency for the next fiscal year at the $80 million level. So while the agency is hiring new staff, the fiscal year 2009 budget proposal by the President would just maintain the staff and not continue to build the professional staff that is needed to protect consumers across America. I do not agree with the President. There has been a dramatic upsurge in imports into the United States, a dramatic increase in products that have to be reviewed by this Commission to make sure that American families are safe.

MISINFORMED APPROACHES TO CONSUMER PROTECTION

At this point, I hope that we can move forward. I hope that we can understand that some of the challenges are very obvious. A CPSC engineer was asked to design a new study of the mechanics and stability of all-terrain vehicles (ATVs). He proposed a cursory review of the latest ATV's on a budget of about $40,000. He was turned down because it cost too much, he was told. How can $40,000 be too much to study a vehicle that literally is responsible for the deaths of hundreds of people and sends hundreds of thousands to emergency rooms each year? It is clearly a case of penny-wise and pound-foolish.

In 2001, CPSC issued an administrative complaint, a first step in litigation leading to a recall, against Daisy Manufacturing Company about their Powerline Airguns. Airgun's BBs were getting stuck in the gun, so children thought the guns were empty and began aiming and shooting at each other. Due to the high velocity BBs, this resulted in deaths and serious injuries among kids. Daisy alleged there was a misuse of the product and an education campaign would solve the problem.

The Commission alleged a defect, which caused the BB to lodge in the gun so that an administrative complaint was issued, but it was then dismissed by the CPSC in 2003 under a new administra-

tion. One of the factors leading to the settlement action was that Daisy Company could have gone out of business if there had been a recall.

Mr. Moore, at the time, your statement took issue with that settlement action, and I quote. "The bottom line is that we are not the business protection agency. We are the Consumer Product Safety Commission. Our responsibility is to protect the public from dangerous consumer products. If we lose sight of that, we will get entangled in endless discussions of company finances while consumers are being put at risk of death or serious injury."

These are clearly issues and many others that we will have to consider, and we will talk about them as we get into this hearing. But at this point, let me turn to my ranking member, Senator Brownback of Kansas.

STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Thank you, Mr. Chairman.

The hearing we did last year on the Consumer Product Safety Commission was an excellent hearing. I thought it was a groundbreaking hearing, and I am pleased to see progress is being made.

I would like to thank Acting Chairman Nord and Commissioner Moore. I will begin by commending you for the steps you have taken to improve the agency and the work and the safety of imported consumer products since our September 12, 2007 hearing. I understand that you used the additional resources we appropriated to improve your import surveillance activities, modernize your product testing, and hire additional product safety inspectors. It is unfortunate that such advances were not made until after all the toy recalls, bad press, and congressional hearings.

We discussed the issue of imported products from China at great length in our earlier hearing, so I will be briefer on that today. But clearly, China is our biggest regulatory challenge since 70 percent of all defective products are coming from that country—70 percent. We must continue to focus our efforts on stopping dangerous and even lethal products from reaching American consumers. This is where the problem is and this is where our focus, I believe, should be. It is hoeing where the weeds are.

I am glad to hear the continuing dialogue with the Chinese and the enhanced ways your agency is communicating with them, but I am concerned that dialogue just is not enough. The memorandum of understanding (MOU) that you have signed with the Chinese must be honored and you must verify—verify—that the Chinese are holding up their end of the bargain. I would recommend that you hold annual, rather than biennial, product safety summits with the Chinese. I still believe that we cannot merely trust China to do what is right.

Certainly regarding product safety, they have given us every reason not to trust them. In fact, just yesterday a Food and Drug Administration (FDA) official testified before a House subcommittee that FDA's working hypothesis is that the contamination of heparin was intentional. Although FDA has not proven this yet, it speaks volumes about the grave concerns we must have about all products coming from China.

I hope that during today's hearing you will be able to identify specific ways you intend to hold China accountable. Again, this is where the problem is and this is where our focus should be. It is a totalitarian system. It does not have a free press. It has graft and corruption that operate within the political system. I think by looking at the exterior factors you would expect a series of problems to probably arise.

So Ms. Nord and Mr. Moore, I thank you for your commitment to protect America's consumers. I look forward to hearing your detailed testimony and what we can do to particularly address the issue of the products that we are seeing coming in from China.

Thank you, Mr. Chairman.

Senator DURBIN. Thanks, Senator Brownback.

I now invite testimony from Chairman Nord and Commissioner Moore. Please proceed.

Ms. NORD. Thank you, Mr. Chairman, Senator Brownback.

A lot has happened at the CPSC since the last time I appeared before you, thanks in large measure to the leadership of this subcommittee and to you personally, Chairman Durbin and Senator Brownback.

The CPSC received a nearly 28 percent increase in our fiscal year 2008 appropriation, and I can report to you that we are putting these new funds to very good use this year and are building a foundation for further growth in 2009.

The consumer product landscape is changing with globalization and a surge in imported products, more technologically complex products, and a dramatic increase in Internet sales. As this landscape changes, so must we.

This afternoon I want to highlight changes we are making with the increase in our 2008 funding and discuss our 2009 budget proposals which are built on this foundation.

The first change is staffing. We started fiscal year 2008 anticipating a staffing level for the year of around 400. Instead, for the first time in many years, the CPSC will end the fiscal year with more people on staff than at the beginning of the year. Our ambitious goal is to begin fiscal year 2009, this October, with the full complement of staff requested for the entire year, an increase of over 50 people since this past January.

While we are staffing up throughout the agency, we are making a special effort to increase our compliance and field staff who are part of CPSC's new Import Surveillance Division, which is a centerpiece of our new import safety initiative. For the first time we will have a team of permanent full-time personnel at selected key ports, supported by a team of technicians, scientists, and lawyers at headquarters, with full access to Customs' technology that will give our team real-time information on consumer product shipments bound for the United States. When a suspect shipment warrants inspection, we will be using the newly acquired XRF technology to screen for violative products.

The second change is in our laboratory. Our lab team tests products sent from our field staff to identify defects and violations, and they provide the scientific backbone to support our rulemakings such as the one we are pushing forward now on upholstered furniture. With more field inspectors and compliance officers, the work

of the lab will grow significantly. As you know very well, the laboratory is housed in a substandard facility. The fiscal year 2008 funding you provided allowed us to begin the modernization a year earlier than we had anticipated, and our fiscal year 2009 budget request allows us to plan to move into a new modern laboratory by the end of 2009. It is anticipated that the new facility will increase our efficiency by accommodating not only our lab staff, but also other technical and scientific staff who work closely with them.

The third change concerns our data management and information technology (IT). The CPSC receives an enormous amount of information, close to half a million individual product incident reports each year. And I have here a couple of samples of a 1-day's run of data of product reports from two different databases. Processing, investigating, and responding to this information is an enormously complex undertaking. Yet it is in this data that we find the clues that point to possible emerging hazards.

Unfortunately, due to the age and limitations of our IT infrastructure, this data is entered in numerous systems that are not integrated with each other. These two databases which have consumer complaints and product incident reports are not integrated. They do not talk to each other. Thus, we have to rely on the keen eyes and the institutional memories of our experienced staff to pick up trends and patterns, an inadequate approach as the agency grows and as our more seasoned staff retires.

Our IT improvement plan will connect these data systems to allow staff to more effectively identify patterns and flag hazards as they emerge. The recently launched early warning system, which initially is focusing on nursery products in the sleep environment, is a pilot program for this data integration project.

Our fiscal year 2009 budget request proposes to build a more comprehensive plan on the foundation provided by the early warning system. We will keep the subcommittee informed of the progress of this work since we do anticipate that additional funding will be needed in fiscal year 2010 to bring the new system online.

Before concluding, I would like to reference two legislative developments that will impact our funding needs.

First, Congress passed the Virginia Graeme Baker Pool and Spa Safety Act after our budget plans were finalized this past December. That law directs us to undertake a number of new enforcement and education requirements and to administer a new grant program. We anticipate returning with an amendment to our budget request for additional funds.

PREPARED STATEMENT

We also anticipate that the CPSC reauthorization bill will be finalized soon. In addition to giving us needed new authorities, it appears that the final bill will include many new mandates for the agency, including as many as 40 new rulemaking requirements. When it is enacted, we undoubtedly will need additional resources above our 2009 budget proposal. In this regard, I look forward to continuing to work with the members and staff to make sure that we have those resources that we need to continue to serve our most important stakeholder, the American consumer.

Thank you.

Senator DURBIN. Thank you, Chairman Nord.
[The statement follows:]

PREPARED STATEMENT OF THE HONORABLE NANCY A. NORD

Thank you for this opportunity to present to you the appropriation request for the U.S. Consumer Product Safety Commission (CPSC) for fiscal year 2009. As the Committee members know, the CPSC is a small, independent and bipartisan agency created by Congress. Our mission is to protect the public from unreasonable risks of injury and death associated with more than 15,000 types of consumer products.

Last December, the appropriations committees significantly increased CPSC's fiscal year 2008 budget by over 27 percent above the previous year. I want to begin my testimony by thanking the Committee, and specifically the Chairman, for your strong support of our agency and our safety mission. The funds that you have provided are helping us lay the necessary groundwork for the agency's expanded initiatives that are presented in the agency's fiscal year 2009 budget request.

FISCAL YEAR 2009 BUDGET REQUEST

For fiscal year 2009, the CPSC is requesting $80 million to carry out our various safety missions for America's families. While the agency's final appropriation for fiscal year 2008 was also $80 million, there are significant expenditures in 2008 that do not recur in 2009. Therefore, an additional $11,800,000 is available in the agency's 2009 budget request compared to the 2008 funding level. With these fiscal year 2008 and 2009 funds, the CPSC will be able to complete the modernization of our testing laboratory, begin to overhaul our information technology (IT) infrastructure, and hire more staff.

The facilities, staff and IT systems provided by this funding will combine to create the foundation we need to begin to build the agency's newest safety programs, including the Early Warning System that I initiated last year to enhance our ability to identify emerging hazards and the Import Safety Initiative that will allow the agency, for the first time in its history, to have a full-time presence at the Nation's ports. These expenditures for laboratory facilities, workspace and IT infrastructure are critical capital investments that must be made now to accommodate current and expected future growth of the agency, especially in tandem with our projected staff increase.

MEETING THE CHALLENGE OF IMPORTED PRODUCTS

Since the CPSC's inception in 1973, the agency's work has contributed substantially to the decline in the rate of deaths and injuries related to hazardous consumer products. Today, the American home environment has never been safer. However, the international marketplace is dynamic, and there is always more work to be done and new challenges to be met.

Perhaps the greatest of these is the import safety challenge. Most of the consumer products that we use today are no longer manufactured in the United States. For example, over 85 percent of toys and 59 percent of electrical products are manufactured in other countries, notably in China. The number of products imported into the United States showed a 200 percent increase from 1997 to 2006.

The Commission has taken aggressive steps to meet this challenge, including ongoing dialogue and initiatives with the Chinese Government; working with the private sector, including Chinese manufacturers directly; and increased surveillance and enforcement activities at the borders and within the marketplace.

To provide a comprehensive and coordinated effort to ensure greater import compliance with recognized American safety standards, the Commission in 2004 created the Office of International Programs. Through this Office we have established a formal relationship between the CPSC and the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), our counterpart agency in China. Formal working groups and action plans with the Chinese Government were set up to focus on key product areas, and they continue to make progress on their immediate goals of developing strategies to address safety problems and to respond quickly to urgent product safety issues.

Last autumn, the CPSC sponsored the U.S.-Sino Product Safety Summit where significant agreements were signed with AQSIQ to strengthen these working groups. China has pledged to increase pre-export inspections, improve compliance with mandatory and consensus standards, and crack down on repeat violators of U.S. safety standards. While we recognize that China is a huge country with thousands of manufacturing facilities and that implementation of these agreements cannot be accomplished overnight, we have begun to see positive results. The CPSC will

continue to work with the Chinese to assure that they fully implement their commitments.

The initial steps that the CPSC has taken to assure the safety of imported goods are an important beginning to our goal of maximizing Chinese industry compliance with U.S. product safety requirements. In this regard, it is essential to convey to them a full understanding of U.S. regulatory requirements. Summaries of provisions of nearly 300 U.S. mandatory and consensus consumer product safety standards are now available in Chinese. We are posting timely information briefs on our website in Chinese, and our plans include links to full Chinese texts and audio-visual products. The agency is also participating in industry-specific safety seminars and retail and vendor training seminars on-site in China.

BUILDING A NEW IMPORT SURVEILLANCE DIVISION

The CPSC is hiring new staff in the areas of hazard identification and reduction, as well as in compliance and field operations. CPSC's number of actual FTEs at the start of calendar year 2008 was under 390; our aggressive goal is to increase that number to 439 by October 1, 2008—a 13 percent increase with more than 50 new employees. Additionally, increased staff training and performance initiatives will enhance retention of CPSC's experienced and skilled employees.

These personnel will enable the agency to expand its monitoring, inspection and testing of products, and especially children's products, as part of our Import Safety Initiative. Our new Import Surveillance Division is designed to be the front line of defense working to prevent dangerous toys and other hazardous products from entering the country and reaching American consumers.

These employees will be specialists trained specifically in import surveillance procedures and will work closely with other Government agencies and with CPSC's compliance officers, technical staff, attorneys, and laboratory personnel. CPSC's new port investigators will track cargo and, with Customs' officials, stop and inspect suspect shipments. High impact ports will be targeted and new measures of import compliance will be established to better assess progress.

MODERNIZING CPSC'S TESTING LABORATORY

When our import surveillance and compliance officers find suspect products, those products are sent to our laboratory to determine if they violate standards or are defective. Therefore, our laboratory is an integral and critical part of our operation. As you know, and as your staff has witnessed first-hand, CPSC's testing laboratory needs to be modernized to create efficiencies and to better support CPSC's product safety work, including the new work generated by the Import Safety Initiative. As presently configured, the laboratory space is inefficient to say the least, though our staff there do an incredible job with the tools that they have at hand.

Our new funding has allowed the agency in 2008 to begin to implement plans that not only address the needs of the laboratory but also anticipate critical and immediate workspace issues for a growing staff. The Commission has been able to move forward with site selection and will make a substantial payment to the General Services Administration of $8 million in fiscal year 2008 so that we can move into the new laboratory a year earlier than otherwise expected. An additional payment of $6 million is requested in CPSC's fiscal year 2009 budget proposal to complete the laboratory project.

By accelerating our laboratory modernization plan, we will provide not only a modern facility for our engineers and scientists to conduct their testing and investigations but also office space for an additional 70 employees to be relocated from CPSC's headquarters office. These employees will be those who work closely with the laboratory staff. This action will allow further efficiencies and improvements in office space at our headquarters site.

IMPROVING CPSC'S IT INFRASTRUCTURE

Per the Committee's interest, the agency is also spending new funding on important improvements to our information technology (IT) infrastructure. The need for increased funding for IT has been a constant in CPSC's budget proposals over the years. Our IT systems have not been fully modernized since 1993 when the agency last relocated its headquarters. As directed by the Committee, CPSC's 2009 budget request includes a report on our information technology modernization requirements.

Achieving the agency mission is dependent on our IT systems because our work requires electronic accessibility of information to maintain productivity. The increased emphasis on import safety demands greater reliance than ever before on in-

tegrating CPSC databases and accessing other agencies' databases, such as those of U.S. Customs and Border Protection, in a seamless fashion.

With new funding in fiscal year 2008, the CPSC has permanently established a long-sought capital fund to replace aging and outdated IT equipment on a systematic basis and a fund to support development of more advanced electronic applications. Additionally, a one-time expenditure of $2.3 million is allowing the agency to replace its resource management information system which is so outmoded that vendor support is being withdrawn.

Funding in fiscal year 2009 will continue this modernization effort and include the development of our IT improvement plan to convert our current data systems from a client-server environment to a web-based environment; full integration of the Document Management System; updating current, outdated database platforms to one, mainstream platform; and converting current, disparate data systems to one data system.

These IT improvements are essential to the agency's Import Safety Initiative. Improved electronic data exchanges with Customs' databases in the future will enhance the Government's capabilities to identify, track and stop hazardous products from entering the United States. Our IT plan will also include a new system that can track historical changes of addresses and names for foreign companies which will provide for more rapid identification of hazardous imported products. The new system will also integrate several third party sources of information that will yield improved monitoring. Finally, it will potentially give us, for the first time, an effective tool to flag and guard against foreign suppliers who repeatedly ignore our product safety requirements.

ESTABLISHING A NEW EARLY WARNING SYSTEM

The new IT improvements will also support our new Early Warning System (EWS) which I initiated last year to enhance our current hazard identification systems. The goal of the EWS is to systematically identify and respond to children's product safety hazards starting with cribs, bassinets and playpens. This initiative is important because it is designed to address emerging hazards more quickly and effectively. Through an enhanced identification system, the agency will be able to detect product hazard patterns more promptly as they emerge.

ONGOING CPSC ACTIVITIES

While I have discussed CPSC's new systems, programs and infrastructure at length, it is also important to recognize the critical ongoing work of the agency in standards setting, domestic enforcement and public education.

Though the Commission was without a quorum for the better part of 2007, I am pleased to report that the agency was able to make progress on a number of fronts. As a result of last year's staff work, the Commission was able to vote earlier this year, before the quorum again expired, on a final rule to update our clothing textile flammability standard and on a notice of proposed rulemaking on upholstered furniture flammability.

Reducing Carbon Monoxide Poisonings

Additionally, the Commission completed a great amount of work to reduce carbon monoxide (CO) poisonings.

First, the Commission issued a mandatory rule last year for a new danger label for portable generators to warn consumers about CO poisoning and to encourage safe use. The regulation became effective on May 14, 2007, for all portable generators manufactured or imported after that date.

Second, the Commission issued an advance notice of proposed rulemaking in December 2006 to initiate a multi-faceted proceeding that includes as its goal reducing consumer exposure to CO through technical means and performance standards that will enable and encourage proper generator placement outdoors.

Third, the CPSC awarded a contract to develop a prototype generator engine with reduced CO in the exhaust.

Fourth, CPSC staff has an interagency agreement with the National Institute of Standards and Technology (NIST) to conduct physical testing and indoor air quality modeling of in-home CO infiltration in various styles of homes when a generator is used in various locations.

Finally, CPSC staff conducted a proof-of-concept demonstration of a remote CO sensing automatic shut-off device, as well as an interlock concept in which a CO sensor was located in the generator. The results of these investigations will help determine practical and effective performance requirements for portable generators and provide the basis for subsequent rulemaking activity.

Implementing a New Mattress Flammability Standard

In 2007, the CPSC's new mattress flammability standard became effective. The staff estimates that the new standard, when fully effective, will prevent as many as 270 deaths and 1,330 injuries annually.

In implementing the new standard, CPSC staff has sponsored and participated in education seminars for manufacturers and retailers. Staff has also developed a dedicated mattress information webpage and prepared and distributed several reference documents and informational brochures.

In addition to the progress the agency has made on these rulemakings, the CPSC is continuing its work in the voluntary standards process by providing expert advice, technical assistance, and information based on data analyses of how deaths and injuries occurred. Staff is currently supporting the development or revision of over sixty voluntary standards, including those to reduce fires related to candles, batteries, appliances and other electrical products.

Enforcement and Compliance Efforts

CPSC's Office of Compliance completed 473 cooperative recalls in 2007 involving approximately 100 million product units. While those 473 recalls in 2007 were heavily publicized in the media, they were only marginally above the 467 cooperative recalls that were completed in 2006, and in fact, they involved fewer than the 120 million product units in 2006. The increased media attention on the CPSC in 2007 did, however, have the salutary effect of raising both public awareness of the agency's safety mission and its effectiveness in removing products from the marketplace that violate mandatory standards or present a substantial risk of injury to the public.

To assist industry in recalling products and complying with our regulations easily and quickly, the agency relies on Fast Track product recalls to streamline the process for firms that are willing and prepared to recall their products promptly. Because every defective product presents a risk of injury or death, removing hazardous products from the marketplace faster can prevent more injuries and save more lives. Recalls under the Fast Track program are conducted without the need for a time-consuming hazard analysis and, over 90 percent of the time, are implemented within 20 days of a firm's report to the CPSC. For non-Fast Track corrective actions, we also established new efficiency goals to complete key actions within a specified time period.

Educating the Public

CPSC's Office of Public Affairs is very active in educating the public and informing consumers of recalls and emerging hazards. In 2007, that Office issued more than 350 press releases on product recalls and safety information and completed more than 20 safety campaigns on such topics as all-terrain vehicles; mattress safety; stove, television and furniture tipovers; portable generator dangers; and outdoor and indoor drowning prevention. American consumers viewed safety information announced by the CPSC more than a half billion times through television interviews, video news releases, free publications, and the Neighborhood Safety Network.

I am especially proud of that Office's work on outreach to the Spanish-speaking community. In 2007, we translated the Neighborhood Safety Network Toolkit into Spanish, as well as several safety publications and three times the number of press releases as in the previous year. The CPSC coordinated a Lead Poisoning Prevention Web site in cooperation with other Federal agencies and the National Council of La Raza.

Before concluding, I should note that the House and the Senate have passed different versions of reauthorization legislation for the CPSC. CPSC's fiscal year 2009 budget request does not include funding increases in the event that Congress finalizes this legislation and the President signs it. Since it is clear that the final legislation would impose substantial new regulatory, enforcement and other mandates on the CPSC, we will, of course, be in further contact with the appropriations Committees in that regard at the appropriate time.

The CPSC is an agency that is undergoing change, like no other agency of Government, with significant budget increases, comprehensive reauthorization, and national attention unlike ever before in its history. As we make the transitions that accompany this change, I look forward to continuing to work closely with the Committee. Our common goal is to assure the safety of the products that American families bring into their homes, schools and recreation areas. I am honored to serve the American public as Acting Chairman of the Consumer Product Safety Commission at this time of great challenge and great opportunity, and I look forward to answering your questions.

Thank you.

Senator DURBIN. Commissioner Moore.

SUMMARY STATEMENT OF THOMAS H. MOORE

Mr. MOORE. Mr. Chairman, Mr. Ranking Member, thank you for providing me with this opportunity to present testimony before you today on the U.S. Consumer Product Safety Commission's fiscal year 2009 appropriations request.

For our current fiscal year 2008, Congress, led by this subcommittee, took up the cause of the American consumer by focusing on, and addressing, the serious deficiencies at the Commission resulting from our most recent years of shrinking resources. Our agency was appropriated $80 million, a $16.75 million increase over the administration's request.

For fiscal year 2009, the President's funding request for the agency is $80 million, which is equal to the level of funding provided by Congress for fiscal year 2008. With this amount of funding, we propose to hire up to a level of 444 full-time employees. Additionally, we propose to continue our efforts to acquire a modern, state-of-the-art laboratory facility and to acquire additional office space, which we will need to accommodate some of our new hires.

The fiscal year 2009 request on its face is a request for level funding from 2008. However, there are a number of one-time expenses occurring in 2008 that are not anticipated in 2009. Not having those expenses in 2009 provides the Commission with $5.8 million to direct toward activities which would give indications of growth as opposed to stagnation or movement in the negative direction.

Most important to me is our now present ability to rebuild our staff. CPSC is a staff-intensive organization, as I have said previously. At the heart of CPSC's operation is its staff, without question our greatest and most important asset.

In addition to Congress' focus on Commission appropriation issues, both Chambers, the House and the Senate, have passed reauthorization legislation. Both bills provide significant increases in our authorization levels for future years at the Commission. The bills would require the Commission to undertake a number of activities that I am not taking into consideration as I present this statement. I cannot say at this time what resources we would need to fully implement any new requirements. When a final package is agreed upon and signed into law, we certainly intend to communicate with this subcommittee with respect to any future requirements and their effect on Commission resources.

Also, last December, the President signed into law the Pool and Spa Safety Act. For fiscal year 2009, the act authorizes $7 million for the Commission to carry out its requirements. Our staff has done an estimate of the cost of carrying out the requirements of the act and has advised the Commission that for fiscal year 2009, we would need an additional—an additional—$7.887 million. The President's request of $80 million does not include this funding and Congress would have to include additional funds above the President's request for the Commission to carry out the act's requirements.

Mr. Chairman, I want to thank this subcommittee for your recognition of the importance of our agency with respect to product

safety for American consumers. The sale of unsafe consumer products remains a major national problem. Because of your attention and assistance, we are now on the way back to firm footing in preventing unsafe, potentially harmful consumer products from causing deaths and injuries to American consumers. The continued support of this subcommittee is essential to a successful fulfillment of our mission.

PREPARED STATEMENT

I thank you again, and I am now available to respond to questions that you may have. Thank you.

Senator DURBIN. Thank you, Mr. Commissioner.

[The statement follows:]

PREPARED STATEMENT OF THOMAS H. MOORE

Mr. Chairman, Ranking Member, and members of the subcommittee, thank you for providing me with this opportunity to present testimony before you today on the U.S. Consumer Product Safety Commission's (CPSC) fiscal year 2009 appropriations request.

In summary, for fiscal year 2009, the President's funding request for the agency is $80,000,000 which is equal to the level of funding provided by Congress for fiscal year 2008. With this level of funding, we propose to hire up to 444 Full Time Equivalents (FTEs) from our budget submission level of approximately 380 FTEs. Additionally, we propose to continue our efforts to acquire a modern laboratory facility and to acquire additional office space, which we will need to accommodate some of our new hires.

However, it must be noted that the fiscal year 2009 funding request does not take into consideration the cost of implementing the requirements of the "Virginia Graeme Baker Pool and Spa Safety Act" nor does the 2009 funding request address the cost of implementing possible requirements of any final passage of a conference agreement on the "Consumer Product Safety Commission Reform Act" as passed by the Senate and the "Consumer Product Safety Modernization Act" as passed by the House.

On December 19, 2007, the President signed into law the Virginia Graeme Baker Pool and Spa Safety Act which is aimed at reducing the 260 pool and spa drownings each year involving children younger than 5 and reducing suction entrapment deaths and injuries. The act addresses pool and spa safety issues by specifying requirements that would make pools and spas safer. The act also authorizes the Commission to establish an incentive-based grant program for States, subject to the availability of appropriations. Additionally, the act requires the Commission to "establish and carry out an education program to inform the public of methods to prevent drowning and entrapment in swimming pools and spas."

For fiscal year 2009, the act authorizes $7 million for the Commission to carry out these requirements. Our staff has done an estimate of the cost of carrying out the requirements of the act and advised the Commission that, for fiscal year 2009, we would need an additional $7.887 million—which would provide for start-up cost, contract cost, the cost of an additional 6 FTEs, and other costs associated with implementing the requirements of the act. As I have indicated, the President's request of $80 million does not include funding for these activities and Congress would have to include additional funds, above the President's request, for the Commission to carry out these requirements.

IMPACT OF FISCAL YEAR 2008 FUNDING

In order to fully understand our fiscal year 2009 request, we must first look at what is transpiring for us in fiscal year 2008. In fiscal year 2008, the administration's budget contemplated funding the Commission at $63,250,000 which would have resulted in an all-time low funded staffing level of 401 FTEs; a decrease of 19 FTEs from the fiscal year 2007 funded level. As I indicated in my written statement to this subcommittee last year, such a funding level would have had a devastating effect on the agency's ability to maintain the broad range of skilled staff we need to address the full scope of the 15,000 types of consumer products under our jurisdiction. Congress, led by this subcommittee, took up the cause of the American consumer by focusing on, and addressing, the serious deficiencies at the Com-

mission resulting from our most recent years of shrinking resources by appropriating $80 million, a $16.75 million increase over the administration's request.

With the additional resources, the Commission has been able to start the process of reversing the effects of the Commission's downward spiral in staffing. The Commission is now able to begin filling critical vacancies, moving our staff level in the positive direction toward 420 FTEs. We have also started a process to reacquire headquarters office space that we forfeited in order to reduce our operating cost.

Part of our staffing increase has been directed to an import safety initiative through the creation of a new Import Surveillance Division in the Office of Compliance and Field Operations. For the first time, CPSC will have permanent, full-time product safety investigators at key ports of entry throughout the United States. Initially, we have identified up to 10 ports where we will assign personnel.

We are also implementing an Early Warning System (EWS) initiative which is designed to identify emerging product safety hazard patterns more quickly and effectively in children's products such as cribs, bassinets and play yards (playpens). Fiscal year 2008 funding will allow staff to continue to develop and implement processes and procedures to evaluate and characterize hazard scenarios and failure modes which should alert the Commission staff that a product hazard may exist and quick action to address it must ensue.

The additional resources for fiscal year 2008 will also allow the Commission to move in the direction of expediting the acquisition of a new state-of-the-art laboratory facility and equipment. We will commit $8 million of fiscal year 2008 funding toward this effort. The Commission is taking the approach of acquiring a new facility as opposed to modernizing the present laboratory site based on current projections by CPSC staff, GSA, and OMB that acquiring a new facility would be a more cost effective, more expeditious, and more efficient process for the Commission than rehabilitating the present laboratory site.

Our laboratory situation is well known to most people who have focused on the problems presented by the Commission's limited resource allocations in recent budgets. We have been trying, through various avenues, to remodel or rebuild our existing facility for many years. We now appear to be getting closer to the reality of a new testing laboratory. The process with GSA has been frustrating, with their stated deadlines to us slipping again and again. Last year when GSA gave us the preliminary estimate of how much they were going to raise the rent at the current laboratory facility (with no improvements) it seemed the last straw. (They have since backed off substantially from the threatened initial rent increase.)

Finally, after much discussion, GSA was willing to start the process of looking at what other facilities might be available to see if the option of moving the lab was more cost effective than rebuilding the present one. Perhaps, by the end of this fiscal year we will have a much better handle on that option, but given the fits and starts of this process I am not as confident as I would like to be about the outcome. The cost estimates we are operating on are numbers from OMB and GSA, based on the assumption that we will indeed find appropriate new space for all of our current and future testing needs as well as office space for perhaps as many as 70 of our other employees. I am hopeful that at the end of this process we will have a clear picture of the efficiency and cost effectiveness of moving in this direction. For now, I must simply go on what information staff is presenting to me on this issue and I have consented to fully exploring this option.

We are also able, for the first time, to establish in our base funding, a capital fund to replace aging and outdated Information Technology (IT) equipment and we are able to dedicate funds to further the process of developing more advanced electronic applications for our IT system. These advanced electronic applications will be essential to the Commission's Import Safety and EWS initiatives as well as an important element in converting our current, disparate database systems to a one-stop data acquisition system. Moreover, we are able to replace our outmoded resource management information system, for which vendor support was withdrawn due to the age of the system. Not included in this budget are resources to integrate and modernize our various database systems into one larger searchable format, an improvement to our data analysis capabilities that we have wanted for a long time. If Congress requires the agency to create additional publicly accessible databases—a move I strongly support—being able to do that in the context of improving our overall data capabilities would be especially helpful.

The fiscal year 2008 increase will additionally provide for other important product safety related activities such as a modest increase in our contract funds for our rulemaking, research, and project support. And, because we need to be able to compete with other governmental agencies and the private sector for qualified candidates to fill our vacancies, the budget increases funds for our staff training and staff performance incentives.

Most important to me in our fiscal year 2008 increase is our now present ability to begin rebuilding our staff. CPSC has been under a glaring spotlight for the last year. While it is not always a comfortable position for the agency to be in, for me, it has been welcomed and much needed attention. It brought to light, especially for Congress, the woeful state of the agency's resources, from its declining staffing levels to its aging and inadequate laboratory facilities. For too many years the agency had been forced to put a brave face on its situation by claiming it could do more with less. When we stopped getting enough resources to meet our basic needs that claim began to ring hollow and the agency was left without the necessary tools to properly police the consumer product marketplace.

Now, not only has Congress shown a willingness to give us the resources we so desperately need, but it has also positioned itself to increase our authorities and responsibilities. I am very thankful for Congress' efforts on our behalf. I do hope, however, that any final authorization bill that Congress passes gives the Commission the necessary time it will need to rebuild to meet our current responsibilities. Once we reach that point, then we can give full concentration to tackling the many new responsibilities that are projected to be part of a final reauthorization package.

Our fiscal year 2009 budget assumes that we will have 444 staff on board for the beginning of fiscal year 2009. This requires us to add nearly 65 new employees, a 17 percent increase over our budget submission level. That will bring us almost back to our fiscal year 2005 staffing level of 446 FTEs. When I first came to the agency in 1995, we had final FTE authority of 487 FTEs and averaged 474 FTEs on board for the year. So we still will need to hire another 30 people in fiscal year 2010 just to get us back up to our 1995 staffing level, a staffing level at which we handled that year's existing responsibilities fairly comfortably.

Over time we hope to be able to hire and train capable replacements for those that have left, but the experience that we have lost due to their departure will take years to recover. I am very optimistic that now, with the change in attitude about the Commission's importance that has manifested itself in our increased funding levels, we will be able to reverse the negative perceptions about the Commission and move in a positive direction on our staffing issues and, therefore, on product safety.

CPSC'S SAFETY WORK CAN CONTINUE IN FISCAL YEAR 2009

By most measures, CPSC provides both tremendous service and tremendous value to the American people and we are very proud of our staff's accomplishments. Our agency is the major factor in the substantial decline in the rate of deaths and injuries related to consumer products since 1974. During that time, through our standards work, compliance efforts, industry partnerships, and consumer information, there has been a 43 percent reduction in residential fire deaths, a 74 percent reduction in consumer product-related electrocutions, a 41 percent reduction in consumer product-related carbon monoxide deaths, an 83 percent reduction in poisoning deaths of children younger than 5 years of age, an 88 percent reduction in baby walker injuries and an 84 percent reduction in crib-related deaths.

The fiscal year 2009 request, on its face, is a request for level funding from fiscal year 2008. What we really have, however, amounts to a $5.8 million increase. Assuming the projections on the lab are accurate, we will spend $2 million less on the lab in 2009 and we have another $3.8 million in other non-recurring, one-time costs that we are funding in 2008 that we don't fund in 2009 for a total of $5.8 million in additional funds for 2009.

Of that, $2.457 million will go to maintaining the costs of the 420 employees we anticipate having on board in fiscal year 2008, along with increases in other fixed costs such as rent. Another $3.218 million will go to hiring 24 new employees to supplement and to provide support for the Import Safety Initiative. We have also targeted $125,000 for travel for the U.S.-Sino Product Safety Summit. While I note that both the pending reauthorization bills anticipate the Commission receiving additional funding for the modernization of our testing and research laboratory, our budget requests for both fiscal year 2008 and fiscal year 2009 are constructed to utilize a large portion of the funding increases provided by Congress for the laboratory modernization, certainly a greatly needed improvement. The rest of the increases begin the crucial staff rebuilding and the acquisition of additional office space to accommodate the additional staff. Those concentrations leaves us little for anything else.

Now, there are certainly many questions remaining unanswered at this time concerning reauthorization legislation requirements. I know that there are many questions about what should be included as part of our request for our fiscal year 2009 budget. At this particular moment, it is extremely difficult to determine what additional staff and funds we will need to meet the new responsibilities that Congress

may give us. We have made no attempt to do that in the fiscal year 2009 budget request as that would have been premature. The Acting Chairman's office in a response to a question presented by House appropriators had staff prepare estimates as to what those resources might be (some of those estimates are already going through second revisions), but we are all flying somewhat blindly until we have a final bill with definite requirements and timelines for Commission action. I hope that the deadlines in the final bill will take into account the time needed to hire and train new employees, to find them adequate office space and to integrate them and their skills into our existing workforce. The Commission hasn't had to hire at this pace since it was first established back in the 1970s.

We at the Commission strongly feel that many, many deaths and injuries have been prevented as a result of the heightened attention given to safety issues by manufacturers and consumers due to CPSC's leadership. However, we are very mindful that the product safety landscape is ever evolving because of more technologically complex products as well as an ever growing emphasis on imports. Last year's heightened activities with respect to imported toys, in particular, clearly illustrate the benefits of a strong CPSC Federal presence in today's consumer product marketplace and therefore provide substantial justification for present and future funding to keep our safety programs intact.

CONCLUSION

As I have indicated, Congress is poised to come to agreement on a final reauthorization package. Both bills under consideration provide significant increases in our authorization levels for future years at the Commission. The authorization levels reflect my own views on how growth should be contemplated for the Commission, and I am hoping that future appropriations will be in line with the House and Senate final agreed upon authorization levels.

As I have previously discussed, the bills would also require the Commission to undertake a number of activities that I am not taking into consideration as I present this statement. The final legislative package will most certainly contain some significant new regulatory, enforcement and other mandates that could have some effect on what resources we would need to fully implement all of the requirements. When a final determination is made, we certainly intend to communicate with this subcommittee with respect to future requirements and their effect on Commission resources.

Mr. Chairman, I want to thank this subcommittee for your recognition of the importance of our agency with respect to product safety for American consumers. The sale of unsafe consumer products remains a major national problem. Because of your attention and assistance, we are now on the way back to firm footing in preventing unsafe, potentially harmful consumer products from causing deaths and injuries to American consumers. The continued support of this subcommittee is essential to a successful fulfillment of our mission.

STAFFING LEVELS

Senator DURBIN. Chairman Nord, if I recall, it was in December when it was clear that we were sending you this pretty substantial increase in your appropriation to $80 million, and I was asking the staff here what kind of staffing levels you had last year at this time. We think it was around 400 million FTE's. Pardon me. 400 FTE's.

Ms. NORD. You have been dealing with other agencies way too long.

Senator DURBIN. I am not sure there is any agency with 400 million. But 400 FTE's.

Now, historically we have talked about where this agency has been. 980 is the high watermark and now apparently at 380, the low watermark. So the question I have is that in the 4-or 5-month period of time that we have sent you the new resources to staff up, it appears you are staffing down. It appears you are losing ground. Some 5 percent of your employees have left and not been replaced, instead of an additional 10 percent being hired. So can you give us

an indication of why the trend line is moving in the wrong direction?

Ms. NORD. Well, we see attrition on a regular basis. You generally see one or two every month leave, and those people have to be replaced to keep you even. But since January, we have brought on 21 new hires. We have got 12 offers out right now. We have got well over 30, almost 40 new positions that are in the mix for being put out for advertisement. So we are working really very, very aggressively to get up to that goal of starting the fiscal year with 444 FTE's.

Senator DURBIN. So are the 21 that you have hired included in the 380 number?

Ms. NORD. If they are on board, they would be included in our current staffing.

Senator DURBIN. What is your current staffing? What number?

Ms. NORD. It is approximately 385 to 390. I will have to give you the precise number.

Senator DURBIN. Well, I do not want you to go out and pick the first person off the street, and I am sure you would not want to.

Ms. NORD. No.

Senator DURBIN. But we sure want to make certain that you understand the sense of urgency. I will tell you why, and I think you know it better than I do.

The biggest scandal last year involved toys. We know that the design for toys for this coming holiday season in December—those were all agreed on last year, and they are currently under manufacture and currently being shipped to the United States. So the new dolls, the new games, whatever they happen to be are on their way. Clearly, we have to be ready to make sure that the American families do not go through the same thing next holiday season that they did the last one.

Ms. NORD. I do understand your sense of urgency and I share that, Senator.

The thing that I would like to point out is that the type of people we are seeking to hire are statisticians, scientists, toxicologists, human factors, engineers. These people are essential to our operations, but they are also in demand in other Government agencies who are also now trying to staff up, as well as in the private sector. So this is something we are committed to doing. We are working full out right now to get ourselves up to the 444. That is our goal and we are working very hard to reach it.

Senator DURBIN. We are going to keep in touch with you to monitor your progress——

Ms. NORD. Good.

Senator DURBIN [continuing]. And hope that you can reach the 444 with competent individuals as quickly as possible.

NEW IMPORT SAFETY INITIATIVE

Let me ask you about the import safety initiative, which will allow you to put permanent, full-time product safety investigators at key ports. How many ports will be part of this initiative and how many investigators will be placed at these ports?

Ms. NORD. We are going to be putting people at 10 different ports. Our overall division is going to be approximately, I believe,

12 people, and I would prefer to give your staff privately the locations of those ports, if I could.

Senator DURBIN. May I ask, if you are talking about one person or slightly more than one person per port, what kind of workload will that person face?

Ms. NORD. Well, they will certainly face a very heavy workload, but the thing that needs to be remembered here is, first, we have to start someplace.

And second, we do anticipate that this is a program that will grow based on our experiences this year.

Third, these people are not out there standing alone. They are supported by technical staff back at headquarters and also, very, very importantly, they are going to be working hand in glove with their colleagues from Customs. And that relationship between CPSC and Customs has grown wonderfully well over this past year, and I am very encouraged by the support that we are getting.

Senator DURBIN. Are you considering any new technology in these ports for the detection of lead or other dangerous substances?

Ms. NORD. Yes. Because of the increased funding that we were able to receive from you, we have now acquired what is known as XRF technology. This is important because it allows us to screen for potential violations. What we had to do before is if the inspector's eye saw something that they thought was suspicious, that product had to be sent back to Washington for testing, and that was a process that took a great deal of time. So this allows us to screen it right there quickly. We can then separate out the things that pass from the things that need a further look.

WILL THERE BE A CPSC PRESENCE IN CHINA?

Senator DURBIN. My last question. Do you expect to place any staff in China?

Ms. NORD. If I have my way, we will.

Senator DURBIN. You are the Acting Chairman.

Ms. NORD. Yes. We have been having conversations with the Beijing Embassy and with the State Department about having a foreign service national assigned to us over there. If we are to send CPSC staff there and put them there, that is a big undertaking for our agency. I believe it requires a vote of the Commission, and at this point, you know, we do not have a quorum. But I think that would be a good thing to do. So I will certainly be voting for it.

Senator DURBIN. I am going to turn this over to Senator Brownback. I have to step out while he questions, but I will be returning.

Senator BROWNBACK. Thank you, Mr. Chairman.

Are you conducting any surprise inspections in China now?

Ms. NORD. We do not do inspections per se in China as, for example, the FDA does. What we are doing is all our recall notices go directly to our counterpart agency in China, and they investigate them. We are now getting very detailed reports back from them as to their findings. We have monthly video conferences where we go over each of the recalls and what their investigations found.

Senator BROWNBACK. What about doing surprise inspections in China? You were talking about putting personnel or somebody at the Embassy there. What about doing surprise inspections?

Ms. NORD. It is clear actually that under our statute we only regulate American product sellers. So we would not have the legal authority to go into a Chinese-owned plant with an American inspector and do an inspection. What will happen is that the Chinese Government does that, and if we have people in China, then they could certainly participate in those inspections, but they would have to be done by the Chinese since they would be inspecting Chinese factories.

Senator BROWNBACK. Therein lies the rub, if you will, because we are getting so much from China and we are having so many problems and their system is so different from ours. That is the problem. You could kind of say, well, okay, China has a free press and so they are going to kind of track these issues or get some light on them. Well, they do not. If they had an open political system where you would have different political parties batting this around, well, okay, maybe that would be something that would produce it. They do not. It is well known the corruption and graft that is taking place at local levels in China. The national level of the Chinese Government is trying to get some competitiveness at a local level because of primarily dealing with graft and corruption that they are trying to get out of the system but is there.

So I do not know how we depend upon the Chinese Government to assure that we get a decent product without us being there and in on surprise inspections.

Ms. NORD. We cannot look to the Chinese Government to enforce American safety laws, and we do not intend to. But what we can do is put in place a number of different kinds of processes that will push toward an ultimate result of safer products, and that is what we were trying to do with the agreements that we signed last September that created a framework for this ongoing activity. That is what we are trying to do with our monthly meetings with the Chinese. That is what we are trying to do with the training sessions that go on in China.

But having said all that, it is very, very important that we also understand that we have got to be looking at layers of protection. We can do all that with China, but we have got to make sure that we are vigilant at the ports, that we have got police on the beat, that is to say, that we recall products when we find violations, and that we put penalties in place.

But one of the things that I think is important for you to know, Senator, is that, first of all, the number of toy recalls and lead paint violations is going way down. And also it is important and I think very good news that we have not yet seen any products manufactured after the point of our agreements that have been recalled for lead paint violations.

Senator BROWNBACK. If I could before my time is up, have the total number of consumer product recalls on imported items from China increased or decreased since September 2007, and not just the lead-based products?

Ms. NORD. I am sorry. I did not have that statistic. The number of recalls that we have done in fiscal year 2008 is going up, but those are products that were already in the marketplace. They are not new products that have entered the marketplace since September. So they are things from 2005, 2006, that kind of thing.

Senator BROWNBACK. Just to conclude on this, when you catch it, the horse is already out of the barn. It is in the consumer marketplace here and that is where we catch it when we ought to be backing up a lot earlier on this. I do not have confidence that, with whatever kind of cooperation we get from the Chinese Government, that they are going to catch this. And at the point at which we catch it, it has already entered the consumer marketplace.

Ms. NORD. That is why the layers of protection is such an important concept. Obviously, consumers are better off if the product is manufactured safely in the first place, and that is what we have to be shooting for.

Senator BROWNBACK. Thank you.

Thank you, Mr. Chairman.

CPSC REAUTHORIZATION

Senator DURBIN. Chairman Nord, when the Consumer Product Safety Commission Reform Act was pending, Commissioner Moore and you sent letters to Chairman Inouye about it, and you have alluded to it in your testimony today. Now, of course, this bill, having passed the Senate, is subject to conference with the House in terms of its outcome.

I just want to make sure that I understand what you have said today. If this bill as passed in the Senate was enacted into law, would this give you more tools and more authority to do your job?

Ms. NORD. It would certainly give us more tools and more authority.

Senator DURBIN. Is there any way that you think provisions of this bill would make your job more difficult?

Ms. NORD. There are a number of new mandates in the legislation and they have very, very short time deadlines on them. So we will either have to come back to you with a plan for staffing up, to the extent we can, or reallocating existing resources, taking things off existing projects and putting them on what is there.

Senator DURBIN. Can you give me any examples of those mandates as you are sitting there?

Ms. NORD. Oh, gosh. The bill set out a whole schedule for doing rulemakings on children's products, durable infant products.

Senator DURBIN. Like tracking labels for children's products?

Ms. NORD. Well, no, doing rulemakings on putting in place rules dealing with durable children's products.

Senator DURBIN. Such as a comprehensive ban on lead?

Ms. NORD. Well, that certainly is there as well, but I was speaking of something else.

Senator DURBIN. I am trying to get down to what you are speaking of. I am not trying to misstate you.

Ms. NORD. The bill tells us on a schedule we are to finalize two rulemakings every year on durable children's products. It also, as you point out, has the ban on lead, and we are working very hard with the authorizers' staff to——

Senator DURBIN. I hope you do not disagree with that mandate.

Ms. NORD. Oh, of course, not.

CONSUMER COMPLAINT DATABASE

Senator DURBIN. What about the online product safety database enhancing public access to product safety information? Does that exist today?

Ms. NORD. No, it does not.

Senator DURBIN. Do you know what it would take to put that database in operation? Have you considered that?

Ms. NORD. Yes. I have asked our information technology people to give us some estimates, and they have advised me that to do what is described in the Senate bill as it passed would take approximately $20 million in startup costs and about $2.5 million to $3.5 million annual maintenance cost.

If I may expand, the database is a very good example of why we really need to get a better handle overall on our information technology needs. Unfortunately, because the agency has been short funded, we have put together databases on an as-needed basis. They are stovepiped. They do not communicate with each other, and for our staff to have the tools it really needs to do its work, we have got to modernize our IT resources.

SENATE CPSC REAUTHORIZATION BILL AND COST ESTIMATES

Senator DURBIN. I would like to ask you, if you would, to take a look at the bill that passed the Senate.

Ms. NORD. Yes.

Senator DURBIN. And if you would give us your best estimate from your staff of where you consider to be the most expensive and the most challenging elements of that bill, I would like to know because I want to get this bill passed. We have been working hard to get the conference committee to go to work on it, and I want to be thinking in terms of next year's appropriation as to what will be needed. For example, this database requirement here. If people can come up with a reasonable estimate of what that might cost, I want to be thinking ahead about what that might require in the next appropriation bill.

I believe in this bill. I introduced an earlier bill which was very similar to it. Senator Pryor improved on it and did a great job leading it through the floor on a bipartisan basis. But I want to think ahead to what these new challenges might be and what their costs might be. It certainly is not going to be served with a remake of the $80 million fiscal year appropriation for this year. It is going to take more.

Ms. NORD. We will need an amendment, and I will be happy to do that.

Senator DURBIN. If you would, please, I would appreciate that very much.

MOST IMPORTANT ELEMENTS OF CPSC REAUTHORIZATION BILL

Commissioner Moore, your letter in reference to this bill was much more supportive in terms of the tools that it would give to your Commission. As you reflect on that, were there any specifics that you had in mind that you think could really make a difference in the way you do your job?

Mr. MOORE. Certainly given the increase in the number of products coming in through our ports, the ability to expand our study and our interest in products as we meet them at the ports, at the docks, I think is very important. To the extent that we can turn products around if they are violative—they do not meet standards—I think the more effective we can be in controlling product safety problems.

Senator DURBIN. Mr. Moore, I think we all understand what happened last year. It was a troubling time for many American families. There were questions raised about toys in particular but other products as well. And a lot of people came up to me in my State and to other Senators and said, what is safe? What is it safe to buy? And I could not tell them. I really did not know the answer to that question. I could not make a recommendation of what to do.

ARE WE BETTER OFF NOW?

Do you feel that there is anything happening at the Commission today which gives you confidence that the next holiday season will be any different or any better?

Mr. MOORE. Well, I think one of the most risky elements of products out there most recently has been lead in children's toys, and I think there has been enough publicity and enough vocal concerns raised about that, that I think the public is very much aware. Also manufacturers are very much aware. And, I think to the extent that we can eliminate that particular problem, that is a major consideration.

Senator DURBIN. It is.

Chairman Nord, let me ask you the same question. Can you tell me with any degree of certainty that the next holiday season, that families can have more peace of mind in the toys and products that they are purchasing, that we will have done a better job or that the process will be any safer?

Ms. NORD. Last Christmas, the toys, because of what happened, were the most tested and examined in the history of our country. We need to build on that. I think that the toy industry safety initiative is a really interesting proposal because, to Senator Brownback's concern, it really does force an examination of the Chinese factories. I think that if I could have one thing only from the authorization bill—this is something I asked for last summer—it is to have certification authority. That would do so much to help us. It would drive testing. It would give us another tool for imports. That simple thing.

CERTIFICATION AUTHORITY

Senator DURBIN. Certifying laboratories?

Ms. NORD. No. Certify that toys meet all relevant standards.

Senator DURBIN. Where would the certification take place?

Ms. NORD. The importer and the product seller would have to get it certified.

Senator DURBIN. Where?

Ms. NORD. If it was manufactured in China, they would have to have it tested there.

Senator DURBIN. So there would be laboratories doing this work.

Ms. NORD. Absolutely.

Senator DURBIN. That we would certify.

Ms. NORD. Absolutely.

Senator DURBIN. And that would, obviously, mean that some CPSC employees would have to be traveling to these laboratories.

Ms. NORD. Well, we would certainly be traveling to these laboratories, but I think we would be setting up a structure that would make sure that the quality control is in place, but that all flows from that simple certification requirement.

Senator DURBIN. Is there any effort underway now, even absent this new reform bill, to establish these laboratories in China, not Government laboratories, but private laboratories, the names of which we might recognize?

Ms. NORD. There are many ongoing efforts. I think the community has anticipated that the bill will pass, and that sets out a very full third party, independent testing and certification requirement. And so they are gearing up for that now.

Senator DURBIN. And are you involved at all in that current undertaking?

Ms. NORD. Yes.

Senator DURBIN. What does the CPSC do?

Ms. NORD. Well, our staff is working very closely with the other Government players who have experience doing this in other areas. I mean, we have an ongoing relationship with all the testing and certification accreditation bodies. You know them as well as I, UL, ANSI, ASTM, and there are many others that have a role to play here, and we work daily with them.

ENDING REMARKS

Senator DURBIN. I do not have any further questions. I want to thank Commissioner Moore and Chairman Nord for being here today.

We are looking forward to receiving your best estimate of what impact the new reform bill might have on your agency. I encourage you as quickly as possible in a professional way to try to get staffed up to make sure that we have the technical staff and investigators, both here in the United States and overseas. If there is any need of this subcommittee or Congress to be involved to help you locate your people in other places, I hope you will turn to us because I hope I made it clear that I do not want to live through what we did last year, and I am sure you do not either.

Ms. NORD. You can be assured of that, Senator.

Senator DURBIN. We learned from that experience, and we owe it to the American people, all of us in Congress and in the executive branch, to do a better job.

ADDITIONAL COMMITTEE QUESTIONS

So the record will be open if my colleagues have questions that they might submit for your consideration. We have made a couple of requests of you here, and I thank you for joining us today.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO NANCY A. NORD

QUESTIONS SUBMITTED TO SENATOR RICHARD J. DURBIN

NEW IMPORT SAFETY INITIATIVE

Question. How will this initiative change your stated goal for fiscal year 2008 for Import Surveillance, which was for staff to conduct port-of-entry surveillance for 1 product for which fire safety standards are in effect?

With the funding increase from fiscal year 2008 and knowing of the limited goals listed in your fiscal year 2008 budget justification, will any of your fiscal year 2009 stated goals for import safety and interaction with China be able to be accelerated into this year?

I know you are using XRF technology. Are there other functional technologies being considered for inspection?

Answer. The 2008 stated goal for one port-of-entry surveillance for fire safety contemplated a focus on compliance with CPSC's new mattress flammability standard. That important initiative is underway. While the stated goals in the Consumer Product Safety Commission's (CPSC) Performance Budget and Operating Plan cannot be changed without a vote of the Commission (and the Commission currently lacks a quorum), the CPSC has been able to use the additional funds provided for fiscal year 2008 to strengthen its import surveillance activities. A substantial portion of the new funds have been used to create the new Import Surveillance Division within the Office of Compliance. This new division includes, for the first time in CPSC history, personnel who work at the ports-of-entry on a full-time basis. The new division already has a staff of 11 employees, most of whom are new to the agency (although all have had significant prior experience in import safety). This increased presence at the ports is yielding a larger number of import samples to be evaluated for conformity with mandatory safety standards.

CPSC staff is currently using our new XRF technology at the ports, and it has proven to be a very efficient and effective screening system in identifying products that may contain lead or be coated with lead paint. CPSC staff is exploring whether there are other functional technologies that could be used for inspection at the ports.

UPDATE ON U.S.-CHINA AGREEMENT

Question. Last year, you announced an agreement between the United States and China on lead paint and consumer product safety.

Can you give me an update on any progress? Do you believe that you'll soon be signing a specific follow up agreement to the framework agreement you announced last year?

What do you see as the tangible benefits of finishing a formal agreement?

Have you observed improvements in China's capacity and willingness to perform compliance and enforcement activities regarding product safety?

What outreach has been conducted as a result of the U.S.-China agreement?

Do you expect any such agreements with other countries?

Answer. The work plans that the CPSC agreed to at the U.S.-Sino Consumer Product Safety Summit held in September 2007 were outcomes of our Memorandum of Understanding (MOU) with the Peoples' Republic of China (PRC) which established the framework for cooperation and outreach. The work plans called for cooperative work in four product categories: toys, lighters, electrical products, and fireworks. Technical experts are now working on exchanges of standards information, training for product testing, and sharing information on best practices in those four product categories.

Since September, CPSC staff has met eight times, either in person or via video conference, with staff of China's General Administration for Quality Supervision, Inspection and Quarantine (AQSIQ) to review recalls and safety issues.

The CPSC has begun a Chinese language service on our web site, where Chinese suppliers and government officials can get updated compliance information in Chinese. We are translating many product safety requirements and posting them on the web site, as well as providing summary descriptions in Chinese that link to full texts in English.

Regarding Chinese cooperation, first it should be stressed that the CPSC does not rely on the Chinese government to enforce U.S. requirements. The CPSC enforces our requirements with American importers. That said, the PRC offered to use its export quality control system to target Chinese-made products that would be recalled if they entered the United States. The CPSC singled out lead paint on toys as a problem and the Chinese agreed to take that on.

—The PRC says it has inspected thousands of factories and revoked hundreds of export licenses for lead paint violations. As we send them case reports, they now send us the results of their investigations, and their reports frequently cite specific remedial action that they have required the Chinese factory to take.
—The Chinese government has stated that no export permit is granted for a painted toy unless the paint on the toy came from an approved lead-free suppliers list.
—The PRC has sponsored numerous high-profile standards and compliance seminars aimed at getting the product safety message to Chinese manufacturers. The CPSC participated in one of these in November.
—CPSC staff has noticed that the Chinese government shows an increased interest in promoting industry best practices for compliance assurance, compared to simply increasing its factory inspections.

Nothing the Chinese government promises and no amount of export control inspection can take the place of major systemic changes in Chinese manufacturing. CPSC staff is working with Chinese suppliers to hasten that change, but it is the U.S. importer that must ensure its product complies with U.S. laws.

At CPSC's invitation, product safety officials from the European Union will join us in China during September for a joint outreach program directed to consumer product exporters. The Chinese government has enthusiastically endorsed this project and has agreed to facilitate access to the appropriate audiences for the compliance outreach seminars.

Because we have found the formal work plan to be an effective mechanism for articulating priorities and specific outcomes, CPSC staff will focus on revising the work plan to capture new priorities rather than creating new formal agreements. New work plan priorities will be the subject of discussions with the Chinese over the coming months. These will be formalized during the U.S.-Sino Safety Summit now being planned for 2009.

With regard to other nations, CPSC staff is negotiating a work plan under a new 2008 MOU with Vietnam which is designed to maximize success in priority product areas, with textiles as a strong candidate for a product area. The CPSC will do a training outreach in Vietnam this year, as well as a joint training outreach in China with the European Union.

NEW IMPROVEMENTS IN IT

Question. You plan to spend a significant amount of the fiscal year 2008 funding we provided ($4.3 million) on information technology enhancements.

What are the improvements you are making and what practical results will be achieved?

How will these upgrades improve the quality of injury and hazard data received by CPSC and the targeting of inspection and compliance activities?

Answer. With the additional funding provided in fiscal year 2008, the CPSC has established both a long-sought permanent capital fund to be used to replace aging and outdated equipment on a systematic basis as well as a second fund to support development of more advanced electronic applications. Additionally, a one-time expenditure of $2.3 million is allowing the agency to replace its resource management information system which is so outdated that vendor support is being withdrawn.

These IT improvements are essential to the agency's new Import Safety Initiative and Early Warning System Initiative (EWS). These improvements lay the foundation for improved electronic data exchanges with Customs and Border Patrol's databases and enhance our capabilities to identify, track and stop hazardous products from entering the United States. Development and implementation of our EWS will enhance our current hazard identification systems. The goal of the EWS is to systematically identify and respond to hazards, quickly and effectively. Through an enhanced identification system, the agency will be better able to quickly detect and initiate action on emerging product-associated hazards.

STATUS OF CPSC LABORATORY

Question. I was pleased to have been helpful in discussions with the General Services Administration about securing a proper laboratory for testing, investigations, and other staffing purposes. I'm glad with the funding we provided, that CPSC will be able to move staff to the laboratory a year earlier than expected.

What is the latest on the laboratory move and expected timetable?

What are the most significant improvements in performance you'll be able to demonstrate as a result of moving to the new laboratory?

Answer. The General Services Administration (GSA) is currently working with those who made offers in the Best and Final Offer stage of the process. GSA has

estimated a July/August completion of this stage of the project. We expect a lease award to be made in early fiscal year 2009, with the occupancy date dependent on build-out requirements.

The new facility will improve the efficiency of CPSC's technical and testing operations by allowing the CPSC to consolidate technical staff currently located at our headquarters in Bethesda and at our laboratory in Gaithersburg, Maryland, in one location and to expand testing and evaluation capacity in support of our Import Surveillance Initiative. The new laboratory will allow for a more efficient use of space through the proper integration of offices and laboratories and is expected to reduce the time currently required to set-up and conduct various tests. The new laboratory will be designed to be more flexible and will permit CPSC staff to adapt the layout to future changes in operational requirements.

Plans also include the design and construction of a Human Factors laboratory within the new facility. This laboratory will provide the CPSC with the capability to perform studies of children's and adults' interaction with various consumer products such as toys.

WHAT ELSE WILL CPSC STUDY THIS YEAR?

Question. Yesterday, I cosponsored legislation to ban bisphenol A (BPA), a chemical found in plastics, from all products made for infants and children up to age 7. I understand that in 2002, the CPSC studied rattles, teething rings, and pacifiers and found BPA in 5 of 13 plastic samples.

Given the growing evidence from new studies that have linked the chemical to cancer, diabetes, behavioral disorders and productive problems, do you now plan to study BPA further, particularly with regard to toys and other items children may put into their mouths?

With the increased resources that you now have, what other issues do you expect to begin to focus on and study?

Nanotechnology?

Answer. Bisphenol A (BPA) is a chemical used in the manufacture of polycarbonate plastics and epoxy resins. The greatest potential for human exposure to BPA is from food contact items. The recent in-depth peer review conducted by the National Toxicology Program (NTP) Center for the Evaluation of Risk to Human Reproduction (CERHR) stated that diet accounts for the vast majority, 99 percent, of human exposure. If BPA migrates out of a food contact surface into food, it is considered an unintentional food additive and would be under the jurisdiction and expertise of the Food and Drug Administration (FDA).

Polycarbonate is used in consumer products where there is a need for a very hard, clear, unbreakable and sturdy plastic. Polycarbonate is used in helmets, pacifier shields, protective gear such as goggles and shin guards, as well as other products, that fall under the jurisdiction of the CPSC.

Polycarbonate is used in some pacifier shields (that prevent the nipple from being swallowed) so that when a child falls, the shield does not shatter, breaking into small parts and exposing the child to a possible choking or laceration injury. Any potential exposure from this product would result from mouthing the shield. In 2000 and 2001, CPSC staff conducted a behavioral observation study on mouthing related to the agency's investigation of exposure to diisononyl phthalates; the results of this study are instructive with regard to BPA. In the behavioral observation study, trained observers monitored the behavior of 169 children between the ages of 3 and 36 months. The study found that the daily mouthing times of children's toys and related products were much lower than expected. Based on these findings, the potential exposure from the pacifier shield would be negligible. As with adults, the preponderant exposure route for children would be through food.

There would be no exposure to BPA expected from compact disks, electronics, helmets, goggles, other protective gear, and related consumer products. It should be noted that polycarbonate plays a very important role in its use in helmets and other protective gear, preventing children from receiving serious head injuries, eye injuries or other bodily injuries while engaging in sports and play.

With respect to nanotechnology, CPSC staff is actively participating in a number of interagency initiatives or initiatives by other groups addressing the production, use, and potential health effects and safety of nanomaterials. These groups include: Nanoscale Science, Engineering and Technology (NSET) subcommittee of the National Science and Technology Council (NSTC) and its working groups such as the Nanotechnology Environmental and Health Implications (NEHI); American National Standards Institute (ANSI); International Life Sciences Institute (ILSI); National Toxicology Program (NTP); ASTM International (ASTM); and International Council on Nanotechnology (ICON).

Participation in these groups and activities fosters communication between CPSC staff and the staff of various federal agencies and other groups. CPSC staff learns about health effects data and the best available practices for the regulation of nanomaterials. These interactions also promote responsible research and development of nanomaterials that can be used in consumer products.

A contractor for the CPSC has completed a literature review of nanomaterials that may be used as flame-retardant (FR) chemicals. The report focuses on the physico-chemical properties of the FR chemicals and also reviews potential exposure and health effects of these compounds.

CPSC staff has met with staff at NIST, EPA, FDA, and NIOSH to identify areas of mutual interest and collaboration. For example, CPSC staff has signed a memorandum of understanding (MOU) with NIST to review nano-flame retardants in various products. CPSC staff is also developing an interagency agreement (IAG) with the National Institute for Occupational Safety and Health (NIOSH) to conduct laboratory investigations of emissions of nanomaterials from selected consumer products.

The increased resources for the CPSC are primarily devoted to three purposes in fiscal year 2008: new laboratory facilities, information technology modernization and additional field staff. However, CPSC staff will continue chemical-related activities focusing on lead in consumer products; nanotechnology; strong sensitizers; ozone-generating air cleaners; the use of flame retardant chemicals in upholstered furniture and mattresses; implementation of the Globally Harmonized System (GHS) for Classification and Labeling; and participation in interagency and international workgroups and committees. Additionally, the staff has begun to investigate phthalate substitutes.

In 2009 all of these current activities are expected to continue. In addition, the staff plans to begin new projects looking at potential health effects on issues that may include the use of aerosol products (such as leather waterproofing sprays) and the presence of stabilizers in plastics.

Question. Is CPSC Collecting Data on Fire-Related Injuries and Deaths?

Your fiscal year 2008 budget justification indicates that you began an evaluation of a new system for collecting data on fire-related injuries and deaths but that additional data collection and investigation for this new system was being suspended pending a review, resulting in temporary cost savings.

Where does this effort stand today? Have you resumed collection and analysis of fire death data and will you continue to collect and evaluate fire injury data?

Answer. Two preliminary studies, one on fire fatalities and the other on fire injuries, have been completed. The preliminary study results are currently undergoing agency review, evaluation and clearance procedures; further work is pending completion of those procedures. The CPSC continues to utilize data provided by the U.S. Fire Administration's National Fire Incident Reporting System and the National Fire Protection Association's Survey of Fire Departments to generate fire loss estimates (fires, death, injuries, and property loss damage) for products within CPSC's jurisdiction.

DATA ANALYSIS—NEW EARLY WARNING SYSTEM PILOT PROGRAM

Question. I understand that with the additional funds provided last year, you will implement a pilot program; an early warning system that will facilitate rapid identification of and action on emerging product-associated hazards.

How will this program work and what products will you focus on?

Answer. The goal of the Early Warning System (EWS) is to enhance CPSC's current hazard identification systems by decreasing the time required to identify and initiate action on emerging product-associated hazards, and increasing accountability for decisions.

In November 2007, CPSC staff initiated an EWS pilot program that targets products found in the sleeping environments of children—cribs, bassinets, and play yards (play pens). The agency's current focus is on mechanical and structural hazards that have the potential to entrap or otherwise fatally injure a child.

A multidisciplinary team of subject matter experts meets weekly to evaluate and characterize the hazard scenarios and failure modes of product-associated incidents received during the previous week. An electronic database has been developed to capture these hazard scenarios, failure modes, and the investigative status.

The automated system that is being developed will include the ability to: consolidate incident information from CPSC's many databases into one incident record, associate records that have like incident scenarios, identify hazard patterns and trends, apply a set of decision rules based on specific hazard characteristics and frequency of occurrence, and assign decision rule-based outcomes.

The next stage in the development of our EWS, currently underway, is proof of concept. Concepts that are developed to automate the program requirements identified in the pilot program will be tested to ensure that system outputs meet the needs of system users and satisfy the project objective.

WHY ARE CPSC GOALS FOR CUSTOMER SATISFACTION DECREASING?

Question. Your fiscal year 2009 budget justification lists annual goals for customer satisfaction. Categories include, but are not limited to: responding to voicemail messages by the next business day; processing incident reports within 8 working hours; and mailing incident information for verification to consumers within 2 business days. In almost every category listed, your goals for 2008 and 2009 are lower than your actual rates for years 2004 through 2007.

Why is that?

Answer. The staff of the National Injury Information Clearinghouse (NIIC) was reduced over the last several years from six full time technical information specialists to the current staff level of three full time technical information specialists. As the agency continues to hire more staff as a result of increased appropriations, the number of staff resources devoted to the NIIC will increase, and pending the restoration of a quorum, the Commission will be reassessing these performance goals when developing the agency's fiscal year 2009 operating plan.

ALL-TERRAIN VEHICLES

Question. I understand that you've collected reports on fatal crashes.

Have you recorded that information in your database so it can be studied?

Have you performed any tests on ATVs to see whether the companies are abiding by agreements on lateral (side) stability?

ATVs used to be mostly three-wheeled vehicles. Moving to more stable, four-wheel models was an improvement, but a side effect was to shift the safety debate to rider behavior and away from ATV design.

Have you challenged manufacturers on the design of four-wheel ATVs or done any meaningful stability testing of four-wheel ATVs in the past decade?

Are most of these ATVs coming from China?

Now that you are hiring more staff, will this be an area of focus?

Answer. CPSC staff collects information on fatalities associated with the use of all-terrain vehicles (ATVs) and records that information in a CPSC ATV database (ATVD) so that the information can be retrieved, reviewed, and analyzed. The ATVD is available to the public on request. The fatality data are gathered from a variety of sources, including news clips; reports submitted to CPSC staff from medical examiners and coroners; consumer reports received via telephone or the Internet; and death certificates received from state and city vital registries.

ATV fatalities generally are assigned for in-depth investigation by CPSC Field Operations staff, who attempt to gather any available information about the:

—incident (date, location, number of deceased persons, a description of the circumstances surrounding the incident and how the incident occurred, number of riders on the ATV when the incident occurred);

—decedent (date of death, age, gender, helmet use, cause of death);

—driver (age, gender, height, weight, alcohol use at time of incident, drug use at time of incident, how the driver learned to operate an ATV);

—ATV (type, manufacturer, brand, model, and engine size);

—environment (type of terrain being traveled at the time of the incident, type of road being traveled at the time of the incident); and

—hazard pattern (e.g., did the ATV overturn? Did the ATV land on the victim?).

CPSC staff uses these fatality data in preparing its annual report of ATV-related deaths and injuries, in special studies requested by the Commission, in support of education initiatives by CPSC's Office of Public Affairs, and in support of voluntary standard and rulemaking activities.

In August and September 2007, Office of Compliance staff requested lateral stability values for all current ATV models from all of the firms with Letters of Understanding (LOUs) with the CPSC. All reported lateral stability values met the requirements that were agreed to when the consent decrees were in effect.

Currently, CPSC Engineering Sciences (ES) staff is examining the current generation of ATVs to become familiar with the static and dynamic testing of ATVs using the latest available technologies. As a part of this effort, ES staff recently tested nine youth ATVs at the U.S. Army Automotive Test Center in Aberdeen, Maryland. This testing consisted of gathering baseline measurements of the vehicles' static stability and preliminary measurements of the vehicles' dynamic performance. In addition, CPSC staff has been developing the capability to perform dynamic testing of

ATVs, has been consulting with vehicle dynamic experts at Aberdeen, plans to test adult ATVs in fiscal years 2008 and 2009, and has been developing a robotic steering system to test ATV stability under a variety of operational conditions, some of which would be too dangerous to perform with a test operator.

In the time since the consent decrees, vehicle technology has evolved in terms of brake systems, suspension systems, and engine horsepower. CPSC staff believes that the exploration of a lateral stability requirement for ATVs, while potentially very useful, is an exceedingly complex task. This is because ATVs are rider-interactive vehicles used in many types of off-road terrains. The effort to address lateral stability issues requires extensive test and evaluation with the cooperation of CPSC staff, industry and other private sector entities.

With regard to ATVs imported from China, a recently-released trade press report indicates that for 2007 about 42 percent of the ATVs sold in the United States were from "nontraditional" companies. Nearly all of these units were from Chinese companies. A report, with a chart showing Chinese ATVs as a proportion of the "nontraditional" ATVs sold in the United States for the years 1997 through 2007, can be found at: http://www.dealernews.com/dealernews/article/articleDetail.jsp?id=512838&searchString=nontraditi.

CPSC staff intends to continue its ATV rulemaking and other activities in 2008 and 2009, as directed by the Commission. Other activities include continued testing of ATVs with the goal of better understanding vehicle stability; information and education activities (see ATVsafety.gov); completion of the next annual report of ATV-related deaths and injuries; and conducting focus groups to address the issue of maximum speed for youth ATVs.

NEW POOL AND SPA SAFETY ACT

Question. Your budget justification indicates that this year, you will begin an education program associated with the Pool and Spa Safety Act, enacted last year.

What specific activities will you undertake?

Answer. On May 21, 2008, the CPSC launched its 2008 media and education campaign on pool safety and drowning prevention by hosting a pre-Memorial Day Weekend news conference. CPSC's news conference and news release focused on new death and injury data, building layers of protection in and around the pool and spa, the importance of constant supervision, and the requirements for public pool and spa owners/operators under the new federal law.

The news conference, the issuance of a video news release, and proactive communication with the media, resulted in: a segment on "The Today Show", a news reader on "Good Morning America", citation of our data on "CBS Evening News" reader, an ABCNews.com story on a CPSC employee who lost her son in a pool drowning, and stories on "CBS Radio", "CNN Radio", "Telemundo", Washingtonpost.com, the Associated Press wire, and in Parenting Magazine. Current data collected by the CPSC shows more than 25 million TV viewers and radio listeners were reached.

In addition, the CPSC is working with two respected companies in the Washington, DC area to disseminate nationally and locally, our TV and Radio Public Service Announcement (PSA) on pool safety, which is entitled "Quickly and Quietly."

The CPSC, in partnership with Safe Kids USA and the American Red Cross, also produced a safety poster on drowning prevention that was specifically designed for our 5,300 Neighborhood Safety Network members, who provide safety information to disadvantaged families.

The agency continues to provide consumers, pool owners, pool operators and others with free copies of our "Guidelines for Entrapment Hazards: Making Pools and Spas Safer" and "Safety Barrier Guidelines for Home Pools" publications.

During the summertime, the CPSC will work closely with Safe Kids USA to respond to news reports of child drownings and will provide critically important safety information and PSAs to media in the affected community.

The CPSC is working hard to educate families on pool and spa safety this year and, pending the availability of appropriations, is preparing to carry out a significantly expanded information and education campaign in fiscal year 2009. This effort, combined with our commitment to effectively implement the new Pool and Spa Safety Act, is aimed at reducing the tragic number of child drownings which occur each year.

YO-YO WATER BALL

Question. In 2003, CPSC announced the results of an investigation into the "Yo-Yo Water Ball", a plastic toy with a stretchy cord, for which CPSC had received 186 reports of incidents in which the toy's cord wrapped around a child's neck. CPSC determined that there was a low but potential risk of strangulation and that the

toy did not meet the standards for a recall. I understand that as of mid-December 2007, CPSC has received more than 400 injury reports related to this toy. And the State of New Jersey has now banned the sale of Yo-Yo Water Balls.

Is CPSC considering taking any action with regard to this dangerous product?

Answer. The CPSC has not received 400 injury reports related to this toy. Incident reports provided to the CPSC do not necessarily involve an injury. For example, many of the incident reports regarding yo-yo water balls were concerns about odors, leaking or possible flammability. The majority of these reports were received before the CPSC issued a public advisory on the product on September 24, 2003. Since that time, incident reports have dropped precipitously. In calendar year 2006 the CPSC received 10 incident reports, four of which were complaints about the product's odor.

When CPSC's professional staff investigated this product in 2003, they decided not to recommend that the Commission ban yo-yo water balls. Staff did not believe that the product met the banning requirements under section 15 of the Federal Hazardous Substances Act. Subsequently, the CPSC worked with ASTM International in their development of a voluntary safety standard for yo-yo water balls. That standard was published in the March 2007 version of ASTM F963.

CPSC QUORUM

Question. CPSC's quorum expired in early February. The CPSC Reauthorization, in conference negotiations right now, and which may be completed in May, would temporarily permit two members of the Commission, if they are not affiliated with the same political party, to constitute a quorum for the transaction of business.

What rulemakings and other items requiring a vote of the Commission do you foresee this year?

What items are pending right now and ready for a vote?

Answer. The Commission's official Regulatory Agenda sets forth the status of all CPSC rulemakings currently underway. A copy of the current Regulatory Agenda is attached. If a CPSC reauthorization bill is enacted into law that reflects the language currently being considered by the Senate/House conference committee, the Regulatory Agenda will have to be very substantially revised to reflect redeployment of Commission personnel resources to address new statutory mandates. In that case, during the remainder of calendar year 2008, the Commission may take official action on project changes to the fiscal year 2008 and 2009 Operating Plans and the CPSC fiscal year 2009 budget submission.

AGENCY RULE LIST—SPRING 2008—CONSUMER PRODUCT SAFETY COMMISSION

Agency	Agenda Stage of Rulemaking	Title	RIN
CPSC	Proposed Rule Stage	Flammability Standard for Upholstered Furniture	3041–AB35
CPSC	Proposed Rule Stage	Possible Revocation or Amendment of Standard for the Flammability of Mattresses and Mattress Pads (Cigarette Ignition).	3041–AC27
CPSC	Proposed Rule Stage	All-Terrain Vehicles	3041–AC28
CPSC	Long-Term Actions	Amendment of Safety Regulations for Cribs	3041–AB67
CPSC	Long-Term Actions	Portable Bed Rails	3041–AB91
CPSC	Long-Term Actions	Safety Standard for Baby Bath Seats	3041–AC03
CPSC	Long-Term Actions	Petition CP 03–1/HP 03–1 Requesting a Standard for Bunk Bed Corner Posts.	3041–AC10
CPSC	Long-Term Actions	Petition CP 04–1/HP 04–1 Requesting Mandatory Fire Safety Standards for Candles and Candle Accessories.	3041–AC22
CPSC	Long-Term Actions	Mandatory Safety Standard for Cigarette Lighters	3041–AC25
CPSC	Long-Term Actions	Proposed Standard To Address Open-Flame Ignition of Bedclothes	3041–AC26
CPSC	Long-Term Actions	Regulatory Options for Infant Pillows	3041–AC30
CPSC	Long-Term Actions	Regulatory Options for Table Saws	3041–AC31
CPSC	Long-Term Actions	Fireworks Devices	3041–AC35
CPSC	Long-Term Actions	Portable Generators	3041–AC36
CPSC	Long-Term Actions	Civil Penalty Factors	3041–AC40
CPSC	Long-Term Actions	Regulatory Options for Lead Toy Jewelry	3041–AC41
CPSC	Completed Actions	Amendment of the Standard for the Flammability of Clothing Textiles.	3041–AB68

VIEW RULE

CPSC RIN: 3041–AB35 Publication ID: Spring 2008
Title: Flammability Standard for Upholstered Furniture

Abstract: On October 23, 2003, the Commission issued an ANPRM to expand the scope of the ongoing upholstered furniture flammability proceeding to include both cigarette and small open flame-ignited fires. The staff developed a draft standard addressing both cigarette and small open flame ignition, and held public meetings in 2004 and 2005 to present and discuss the draft. In January, 2006, the staff sent a briefing package containing a revised draft standard and describing regulatory options to the Commission and provided follow-up status reports on various technical research efforts in November 2006 and December 2006. The staff forwarded another options package to the Commission in November 2007. The Commission voted to propose a rule based on the 2007 draft standard. The Commission's proposed standard would not require FR chemicals in fabrics or fillings.

Agency: Consumer Product Safety Commission (CPSC)

Priority: Economically Significant

RIN Status: Previously published in the Unified Agenda

Agenda Stage of Rulemaking: Proposed Rule Stage

Major: Yes

Unfunded Mandates: No

CFR Citation: 16 CFR 1640 (To search for a specific CFR, visit the Code of Federal Regulations.)

Legal Authority: 15 USC 1193, Flammable Fabrics Act; 5 USC 801

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
ANPRM	06/15/1994 ..	59 FR 30735
Commission Hearing May 5 & 6, 1998 on Possible Toxicity of Flame Retardant Chemicals.	03/17/1998 ..	63 FR 13017
Meeting Notice	03/20/2002 ..	67 FR 12916
Notice of September 24 Public Meeting	08/27/2003 ..	68 FR 51564
ANPRM	10/23/2003 ..	68 FR 60629
ANPRM Comment Period End	12/22/2003 ..	
Staff Held Public Meeting	10/28/2004 ..	
Staff Held Public Meeting	05/18/2005 ..	
Staff Sends Status Report to Commission	01/31/2006 ..	
Staff Sends Status Report to Commission	11/03/2006 ..	
Staff Sends Status Report to Commission	12/28/2006 ..	
Staff Sends Options Package to Commission	12/22/2007 ..	
Commission Votes to Direct Staff to Prepare Draft NPRM	12/27/2007 ..	
Staff Sends Draft NPRM to Commission	01/22/2008 ..	
Commission Decision to Publish NPRM	02/01/2008 ..	
NPRM	03/04/2008 ..	73 FR 11702
NPRM Comment Period Ends	05/19/2008 ..	

Regulatory Flexibility Analysis Required: Undetermined

Government Levels Affected: Undetermined

Federalism: Undetermined

Included in the Regulatory Plan: Yes

RIN Data Printed in the FR: No

Agency Contact: Dale R. Ray, Project Manager, Consumer Product Safety Commission, Directorate for Economic Analysis, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7704. Email: dray@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC27 Publication ID: Spring 2008

Title: Possible Revocation or Amendment of Standard for the Flammability of Mattresses and Mattress Pads (Cigarette Ignition)

Abstract: The Commission published an advance notice of proposed rulemaking (ANPRM) in the Federal Register on June 23, 2005, requesting comments on a rulemaking proceeding that could result in revoking or amending its existing flammability standard that includes a test for cigarette ignition of mattresses and mattress pads (16 CFR part 1632). On January 13, 2005, the Commission issued a proposed flammability standard for mattresses and mattress and foundation sets that prescribes an open flame ignition test. Some commenters to that rulemaking stated that they believe that once the new mattress standard is in effect the cigarette ignition test currently required in 16 CFR 1632 will not be necessary and conducting

both tests will be burdensome for industry. The Commission issued this ANPRM to begin consideration of whether the existing mattress standard should be revoked or amended. The staff is analyzing the public comments. A research project examining the criteria for self-sustained smoldering began in late 2006.

Agency: Consumer Product Safety Commission (CPSC)

Priority: Substantive, Nonsignificant

RIN Status: Previously published in the Unified Agenda

Agenda Stage of Rulemaking: Proposed Rule Stage

Major: Undetermined

Unfunded Mandates: Undetermined

CFR Citation: 16 CFR 1632 (To search for a specific CFR, visit the Code of Federal Regulations.)

Legal Authority: 15 USC 1193, Flammable Fabrics Act

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
ANPRM	06/23/2005 ..	70 FR 36357
ANPRM Comment Period End	08/22/2005 ..	
Research Project Begins	09/30/2006 ..	
Research Project Completed	09/00/2008 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined

Government Levels Affected: Undetermined

Federalism: Undetermined

Included in the Regulatory Plan: No

RIN Data Printed in the FR: No

Agency Contact: Patricia K. Adair, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7536. Email: padair@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC28 Publication ID: Spring 2008

Title: All-Terrain Vehicles

Abstract: On October 14, 2005, the Commission published an advance notice of proposed rulemaking (ANPRM) concerning all terrain vehicles (ATVs). Issuance of the ANPRM initiated a rulemaking proceeding under the Consumer Product Safety Act (CPSA) and the Federal Hazardous Substances Act (FHSA). After reviewing the regulatory alternatives and the comments submitted in response to the ANPRM, the staff developed a May 31, 2006, briefing package recommending that the Commission issue a notice of proposed rulemaking (NPRM) that would formally ban three-wheeled ATVs and mandate performance, training, labeling, and information requirements for four-wheeled ATVs. Other non-regulatory activities also were recommended, including the launch of an ATV safety Web site and a two-phase information and education effort. A Commission briefing was held on June 15, 2006. On July 12, 2006, the Commission voted 3–0 to approve publication of the draft NPRM with changes in the Federal Register. The NPRM was published on August 10, 2006, with a comment closing date of October 24, 2006. Seven ATV manufacturers and distributors requested a 60-day extension of the comment period. The Commission granted their request, and the comment closing date was extended to December 26, 2006. Staff is conducting research as directed by the Commission in its vote on July 12, 2006. On February 13, 2008, staff sent a report to the Commissioners summarizing the status of the staff's research activities.

Agency: Consumer Product Safety Commission (CPSC)

Priority: Substantive, Nonsignificant

RIN Status: Previously published in the Unified Agenda

Agenda Stage of Rulemaking: Proposed Rule Stage

Major: Undetermined

Unfunded Mandates: Undetermined

CFR Citation: 16 CFR 1307; 16 CFR 1410; 16 CFR 1500; 16 CFR 1515 (To search for a specific CFR, visit the Code of Federal Regulations.)

Legal Authority: Consumer Product Safety Act; 15 USC 1261; Federal Hazardous Substances Act

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff sends draft ANPRM to Commission	09/15/2005 ..	
Commission Decision	10/05/2005 ..	
ANPRM	10/14/2005 ..	70 FR 60031
ANPRM Comment Period Closes	12/13/2005 ..	
Staff Sends Briefing Package to Commission	05/31/2006 ..	
Commission Decision	07/12/2006 ..	
NPRM	08/10/2006 ..	71 FR 45903
NPRM Comment Period Extended	10/20/2006 ..	71 FR 61923
NPRM Comment Period Closes	10/24/2006 ..	
NPRM Comment Period Closes	12/26/2006 ..	
Staff Sends Status Report to Commissioners	02/13/2008 ..	
Staff Send Second Status Report to Commission	06/00/2008 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Elizabeth W. Leland, Project Manager, Consumer Product Safety Commission, Directorate for Economic Analysis, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7706. Email: eleland@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AB67 Publication ID: Spring 2008
Title: Amendment of Safety Regulations for Cribs
Abstract: On December 16, 1996, the Commission published an advance notice of proposed rulemaking (ANPRM) to begin a proceeding that could result in amendment of the safety regulations for full-size and non-full-size cribs, 16 CFR parts 1508 and 1509. Among the regulatory alternatives under consideration is amendment of the regulations to add tests to assure that slats will not disengage from the side panels of cribs. The Commission began this proceeding after considering information about incidents in which crib slats disengaged from the side panels of cribs, creating a risk that children may become entrapped between the remaining slats or fall out of the crib. At the urging of CPSC staff, in April 1999, the voluntary standard for cribs designated, "Specification for Full Size Baby Cribs (ASTM F1169–99)," and published by ASTM International was revised to include performance requirements for crib slats. CPSC staff is currently assessing the adequacy of and conformance with the voluntary standard. Following this assessment, the staff will prepare a briefing package for Commission consideration as to whether to continue the rulemaking.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: 16 CFR 1508 to 1509 (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 5 USC 553, Administrative Procedure Act; 15 USC 1261, Federal Hazardous Substances Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff Recommended Revisions to Voluntary Standard	09/30/1996 ..	
ANPRM	12/16/1996 ..	61 FR 65996
ANPRM Comment Period End	02/14/1997 ..	
Revisions to Voluntary Standard Approved	04/10/1999 ..	
Voluntary Certification Program Begins	03/01/2000 ..	
Staff Began Monitoring Adequacy of and Conformance with Revised Voluntary Standard	03/27/2001 ..	

TIMETABLE—Continued

Action	Date	FR Cite
Staff Completes Monitoring Adequacy and Conformance	(1)	
Staff Sends Briefing Package to Commission	(1)	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Patricia L. Hackett, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7577. Email: phackett@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AB91 Publication ID: Spring 2008
Title: Portable Bed Rails
Abstract: The Commission is considering whether certain portable bed rails present an unreasonable risk of injury that should be regulated. A portable bed rail is a device intended to be installed on an adult bed to prevent a child from falling out of the bed. Such bed rails may be constructed in a manner that allows children to become entrapped between the portable bed rail and the bed. This entrapment can result in serious injury or death. In October 2000, the Commission issued an advance notice of proposed rulemaking (ANPRM) addressing this issue. The ASTM International standard for bed rails has since been revised and staff is evaluating the adequacy of, and conformance to, the revised standard. Following this evaluation, the Commission staff will prepare a briefing package for Commission consideration as to whether to continue the rulemaking.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 15 USC 1261, Federal Hazardous Substances Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff Sent Briefing Package to Commission	06/28/2000 ..	
Commission Decision	09/21/2000 ..	
ANPRM	10/03/2000 ..	65 FR 58968
ANPRM Comment Period End	12/04/2000 ..	
Staff Sent Briefing Package to Commission	10/01/2001 ..	
Commission Decision	10/30/2001 ..	
Staff Begins Evaluating Conformance to Voluntary Standard	10/01/2005 ..	
Staff Sends Briefing Package to Commission	(1)	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Patricia L. Hackett, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7577. Email: phackett@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC03 Publication ID: Spring 2008

Title: Safety Standard for Baby Bath Seats

Abstract: An advance notice of proposed rulemaking (ANPRM), published in the Federal Register on August 1, 2001, requested comments on a rulemaking proceeding that could result in a mandatory rule addressing baby bath seats. These are consumer products used to hold an infant in a bathtub while the child is being bathed. The staff briefed the Commission on July 28, 2003, and the Commission received oral comments from the public on the same date. The staff evaluated the comments received at the hearing and sent a briefing package to the Commission. In October of 2003, the Commission voted to direct the staff to prepare a notice of proposed rulemaking (NPRM) for the Commission's consideration. On December 29, 2003, the NPRM was published in the Federal Register. The comment period closed on March 15, 2004. Since the NPRM, staff worked with ASTM International to revise the voluntary standard for bath seats (ASTM F1967). The standard was revised in 2004 and again in 2007. Staff is currently evaluating the adequacy of the revised standard. Following this evaluation, staff will prepare a briefing package for Commission consideration as to whether to continue the rulemaking.

Agency: Consumer Product Safety Commission (CPSC)

Priority: Substantive, Nonsignificant

RIN Status: Previously published in the Unified Agenda

Agenda Stage of Rulemaking: Long-Term Actions

Major: Undetermined

Unfunded Mandates: Undetermined

CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)

Legal Authority: 15 USC 1261, Federal Hazardous Substances Act

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
ANPRM	08/01/2001 ..	66 FR 39692
ANPRM Comment Period End	10/01/2001 ..	
Staff Sends Briefing Package to Commission	05/08/2003 ..	
Staff Briefed Commission	07/28/2003 ..	
Hearing	07/28/2003 ..	
Commission Decision	10/16/2003 ..	
NPRM	12/29/2003 ..	68 FR 74878
NPRM Comment Period End	03/15/2004 ..	
Staff Begins Monitoring Progress of Voluntary Standard	10/01/2005 ..	
Staff Completes Monitoring Progress of Voluntary Standard	(1)	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined

Government Levels Affected: None

Federalism: Undetermined

Included in the Regulatory Plan: No

RIN Data Printed in the FR: No

Related RINs: Related to 3041–AB93

Agency Contact: Patricia L. Hackett, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7577. Email: phackett@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC10 Publication ID: Spring 2008

Title: Petition CP 03–1/HP 03–1 Requesting a Standard for Bunk Bed Corner Posts

Abstract: A petition from the Danny Foundation requests that the Commission establish a standard to address an alleged hazard of strangulation posed by bunk bed corner posts. The petitioner asserts that due to the height of bunk beds, corner posts on bunk beds pose a substantial risk to children when the children's clothing, bedding, or other items become caught on the corner posts. On November 8, 2002, the Commission published a notice in the Federal Register to solicit comments on the petition from all interested persons. The comment period closed on January 7, 2003. On April 13, 2004, the staff sent a briefing package to the Commission on this issue.

On July 30, 2004, the Commission voted to defer action on the petition while the staff continues to work with the ASTM International bunk bed subcommittee on this issue. A revised voluntary standard for bunk beds was published in October 2004 that incorporates warning language about hangings associated with bunk beds and attaching items to the bed. CPSC staff worked with the subcommittee to develop requirements to address strangulation hazards with vertical protrusions. A revised standard was approved on July 15, 2007. Staff is currently evaluating the adequacy of the revised standard.

Agency: Consumer Product Safety Commission (CPSC)

Priority: Substantive, Nonsignificant

RIN Status: Previously published in the Unified Agenda

Agenda Stage of Rulemaking: Long-Term Actions

Major: Undetermined

Unfunded Mandates: No

CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)

Legal Authority: 5 USC 553(e), Administrative Procedure Act; 15 USC 1262(j), Federal Hazardous Substances Act; 15 USC 2058(i), Consumer Product Safety Act

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Petition Docketed	10/23/2002 ..	
Notice	11/08/2002 ..	67 FR 68107
Comment Period End	01/07/2003 ..	
Staff Sends Briefing Package to Commission	04/13/2004 ..	
Commission Votes To Defer Action	07/30/2004 ..	
Staff Sends Briefing Package to Commission	([1])	
Staff Begins Evaluating Conformance to Voluntary Standard	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined

Government Levels Affected: None

Federalism: No

Included in the Regulatory Plan: No

RIN Data Printed in the FR: No

Agency Contact: Susan Bathalon, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7566. Email: sbathalon@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC22 Publication ID: Spring 2008

Title: Petition CP 04–1/HP 04–1 Requesting Mandatory Fire Safety Standards for Candles and Candle Accessories

Abstract: The National Association of State Fire Marshals requests that the Commission issue mandatory safety standards for candles and candle accessories such as candleholders. The request was docketed as a petition for rulemaking on March 10, 2004. A notice requesting comment on the petition was published in the Federal Register on April 6, 2004. The comment period closed on June 7, 2004. On July 10, 2006, CPSC staff sent a briefing package to the Commission for consideration and recommended that the Commission defer action on the petition. On July 19, 2006, the Commission voted 3–0 to defer the petition and directed the staff to provide updates on the progress of voluntary standards activities. Staff provided a status report to the Commissioners on June 6, 2007.

Agency: Consumer Product Safety Commission (CPSC)

Priority: Substantive, Nonsignificant

RIN Status: Previously published in the Unified Agenda

Agenda Stage of Rulemaking: Long-Term Actions

Major: Undetermined

Unfunded Mandates: Undetermined

CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)

Legal Authority: 5 USC 553(e), Administrative Procedure Act; 15 USC 2051, Consumer Product Safety Act; 15 USC 1261, Federal Hazardous Substances Act

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Petition Docketed	03/10/2004 ..	
Notice	04/06/2004 ..	69 FR 18059
Comment Period End	06/07/2004 ..	
Staff Sends Briefing Package to Commission	07/10/2006 ..	
Commission Votes to Defer Action	07/19/2006 ..	
Staff Sends Update on Progress of Voluntary Standards Activities to Commissioners	06/06/2007 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: None
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact:, Allyson Tenney, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7567. Email: atenney@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC25 Publication ID: Spring 2008
Title: Mandatory Safety Standard for Cigarette Lighters
Abstract: In November 2001, a petition from the Lighter Association, Inc. requested that the Commission issue a rule to adopt an ASTM International voluntary safety standard for cigarette lighters. In November 2004, the Commission voted to grant the petition and initiate a rulemaking proceeding. An advance notice of proposed rulemaking (ANPRM) was published in April 2005 and the comment period closed on June 10, 2005. Staff completed monitoring conformance of lighters with the voluntary standard, and sent a status report to the Commission for consideration in October 2006. On January 23, 2008, staff provided a review of applicable law, decision factors, and pertinent information to assist the Commission in considering whether to formally rely upon the voluntary standard for cigarette lighters. The Commission did not agree on this approach.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 5 USC 553(e); Administrative Procedure Act; 15 USC 2051; Consumer Product Safety Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff Sent Draft ANPRM to Commission	03/25/2005 ..	
Commission Decision	03/31/2005 ..	
ANPRM	04/11/2005 ..	70 FR 18339
ANPRM Comment Period End	06/10/2005 ..	
Staff Begins Monitoring of Conformance with Voluntary Standard	10/01/2005 ..	
Staff Completes Monitoring of Conformance with Voluntary Standard	05/15/2006 ..	
Staff Sent Status Report to Commission	10/10/2006 ..	
Staff Sent Briefing Package to Commission	01/23/2008 ..	
Commission Decision	02/01/2008 ..	
Next Action Undetermined	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No

RIN Data Printed in the FR: No
Agency Contact: Rohit Khanna, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7546. Email: rkhanna@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC26 Publication ID: Spring 2008
Title: Proposed Standard To Address Open-Flame Ignition of Bedclothes
Abstract: On January 13, 2005, the Commission published an advance notice of proposed rulemaking (ANPRM) to begin a proceeding for development of a flammability standard to address risks of death, injury, and property damage from fires associated with open-flame ignition of bedclothes. Bedclothes are a major contributor to mattress ignition. Commission staff reviewed research indicating that mattresses and bedclothes operate together as a system in fires involving mattresses. Research has suggested that improved flammability performance of some bedclothes can reduce the fire hazard. The Commission staff will review public comments received on the ANPRM and consider how information derived from implementation of the new open flame mattress standard impacts bedclothes flammability. Staff will prepare a decision package for Commission consideration.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Economically Significant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: 16 CFR 1634 (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 15 USC 1193; Flammable Fabrics Act; 5 USC 801
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
ANPRM	01/13/2005 ..	70 FR 2514
ANPRM Comment Period End	03/14/2005 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Allyson Tenney, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7567. Email: atenney@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC30 Publication ID: Spring 2008
Title: Regulatory Options for Infant Pillows
Abstract: On July 13, 2006, the Commission voted 3–0 to grant a petition requesting that the Commission amend the ban on infant pillows under 16 CFR 1500.18(a)(16)(i). The staff prepared a draft advance notice of proposed rulemaking (ANPRM) concerning infant pillows to initiate a rulemaking proceeding under the Federal Hazardous Substances Act (FHSA) to identify the product and the risk of injury associated with infant pillows, summarize regulatory alternatives, and invite comments from the public. On September 27, 2006, the Commission issued the ANPRM. Staff reviewed public comments and prepared an options briefing package for Commission consideration. On February 1, 2008, the Commission voted 2–0 to exempt certain nursing pillows from the ban on infant pillows and to terminate rulemaking.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined

Unfunded Mandates: No
CFR Citation: 16 CFR 1500.18(a)(16)(i)
Legal Authority: 5 USC 553, Administrative Procedure Act; 15 USC 1261, Federal Hazardous Substances Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff sends Draft ANPRM to Commission	09/07/2006 ..	
Commission Decision	09/14/2006 ..	
ANPRM	09/27/2006 ..	71 FR 56418
ANPRM Comment Period Ends	11/27/2006 ..	
Staff Sends Briefing Package to Commission	01/24/2008 ..	
Commission Decision	02/01/2008 ..	
Staff Drafts FR Notice	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Suad Wanna-Nakamura, Ph.D., Project Manager, Consumer Product Safety Commission, Directorate for Health Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7252. Email: swanna-nakamura@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC31 Publication ID: Spring 2008
Title: Regulatory Options for Table Saws
Abstract: On July 11, 2006, the Commission voted 2–1 to grant a petition requesting that the Commission issue a rule prescribing performance standards for a system to reduce or prevent injuries from contacting the blade of a table saw. The Commission also directed the staff to prepare an advance notice of proposed rulemaking (ANPRM) initiating a rulemaking proceeding under the Consumer Product Safety Act (CPSA) to identify the product and the risk of injury associated with table saw blade contact injuries, summarize regulatory alternatives, and invite comments from the public. A draft advance notice of proposed rulemaking will be prepared for Commission consideration.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 5 USC 553(e), Administrative Procedure Act; 15 USC 2051, Consumer Product Safety Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff Sends ANPRM to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Caroleene Paul, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7540. Email: cpaul@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC35 Publication ID: Spring 2008
Title: Fireworks Devices
Abstract: The staff prepared a draft advance notice of proposed rulemaking (ANPRM) concerning fireworks devices requesting comments on whether there is a need for the agency to update and strengthen its regulation of fireworks devices and sent it to the Commission for consideration on June 26, 2006. On June 30, 2006, the Commission voted 3–0 to issue an advance notice of proposed rulemaking. The ANPRM was issued on July 12, 2006. The comment period on the ANPRM closed on September 11, 2006. Commission staff is evaluating comments received.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: Undetermined
CFR Citation: 16 CFR 1500; 16 CFR 1507 (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 15 USC 1261, Federal Hazardous Substances Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff sends draft ANPRM to Commission	06/26/2006 ..	
Commission Decision	06/30/2006 ..	
ANPRM	07/12/2006 ..	71 FR 39249
Comment Period Closes	09/11/2006 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact:, James Joholske, Compliance Officer, Office of Compliance, Consumer Product Safety Commission, 4330 East-West Highway, Bethesda, MD 20814. Phone: 301 504–7527. Email: jjoholske@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC36 Publication ID: Spring 2008
Title: Portable Generators
Abstract: On December 5, 2006, the Commission voted 2–0 to issue an advance notice of proposed rulemaking (ANPRM) under the Consumer Product Safety Act (CPSA) concerning portable generators. The ANPRM discusses regulatory options that could reduce portable generator-related deaths and injuries, particularly those related to carbon monoxide poisoning. The ANPRM was published in the Federal Register on December 12, 2006. Staff reviewed public comments and is conducting technical activities. Staff awarded a contract to develop a prototype generator engine with reduced CO in the exhaust and entered into an interagency agreement (IAG) with the National Institute of Standards and Technology (NIST) to model the buildup and concentration of CO in various locations. NIST will also verify the efficacy of the prototype generator in reducing CO. In addition, staff conducted a proof-of-concept demonstration of a remote CO sensing automatic shutoff device for a portable generator, as well as an interlock concept in which a CO sensor was located on the generator.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: Undetermined
CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 15 USC 2051, Consumer Product Safety Act

Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff Sends ANPRM to Commission	06/29/2006 ..	
Staff Sends Supplemental Material to Commission	10/12/2006 ..	
Commission Decision	10/26/2006 ..	
Staff Briefs Commission	10/26/2006 ..	
Staff Sends Draft ANPRM to Commission	11/21/2006 ..	
ANPRM Published	12/12/2006 ..	71 FR 74472
Comment Period Ends	02/12/2007 ..	
Staff Sends NPRM Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact: Janet L. Buyer, Project Manager, Consumer Product Safety Commission, Directorate for Engineering Sciences, 4330 East-West Highway, Bethesda, MD 20814. Phone: 301 504–0508. Email: jbuyer@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC40 Publication ID: Spring 2008
Title: Civil Penalty Factors
Abstract: Section 20(b) and (c) of the Consumer Product Safety Act, 15 USC 2069(b) and (c), require certain factors to be considered in assessing and compromising civil penalties. The Commission proposed a new interpretive rule that identifies and explains related factors that may be considered by the Commission and staff in evaluating the appropriateness and amount of a civil penalty. On July 12, 2006, the Commission solicited comments on a proposed new interpretive rule. The comment period closed on August 11, 2006. CPSC staff will prepare a briefing package for Commission consideration concerning the content of a possible final interpretive rule.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: 16 CFR 1119 (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 15 USC 2069(b) and (c), Consumer Product Safety Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Notice of Proposed Interpretive Rule	07/12/2006 ..	71 FR 39248
Comment Period End	08/12/2006 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: Undetermined
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact:, John Gibson Mullan,, Assistant Executive Director, Compliance and Field Operations, Consumer Product Safety Commission, 4330 East-West Highway, Bethesda, MD 20814. Phone: 301 504–7626. Email: jmullan@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AC41 Publication ID: Spring 2008
Title: Regulatory Options for Lead Toy Jewelry
Abstract: On December 11, 2006, the Commission voted 2–0 to grant a petition requesting a ban on toy jewelry containing more than 0.06 percent lead by weight. On December 27, 2006, the Commission approved an advance notice of proposed rulemaking (ANPRM), which was published in the Federal Register on January 9, 2007. The public comment period ended March 12, 2007. CPSC staff is reviewing public comments and will prepare a briefing package for Commission consideration as to whether to continue with rulemaking.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant
RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Long-Term Actions
Major: Undetermined
Unfunded Mandates: No
CFR Citation: Not Yet Determined (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 5 USC 553, Administrative Procedure Act; 15 USC 1261, Federal Hazardous Substances Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Commission Decision on Draft ANPRM FR Notice	12/27/2006 ..	
ANPRM Published	01/09/2007 ..	72 FR 920
Comment Period Ends	03/12/2007 ..	
Staff Sends Briefing Package to Commission	([1])	

[1] To Be Determined.

Regulatory Flexibility Analysis Required: Undetermined
Government Levels Affected: None
Federalism: Undetermined
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
Agency Contact:, Kristina Hatlelid, Ph.D., Project Manager, Consumer Product Safety Commission, Directorate for Health Sciences, 4330 East-West Highway, Bethesda, MD 20814–4408. Phone: 301 504–7254. Email: khatlelid@cpsc.gov.

VIEW RULE

CPSC RIN: 3041–AB68 Publication ID: Spring 2008
Title: Amendment of the Standard for the Flammability of Clothing Textiles
Abstract: The Standard for the Flammability of Clothing Textiles prohibits the manufacture, importation, or sale of clothing and fabrics and related materials intended for use in clothing, which are dangerously flammable because of rapid and intense burning. The standard prescribes the apparatus, procedure, and criteria to be used for testing to determine compliance with that standard. The standard was made mandatory by the Flammable Fabrics Act of 1953 (Pub. L. 83–88, 67 Stat. 111; June 30, 1953). Some of the equipment and procedures specified by the standard, particularly those for laundering and cleaning of test specimens, have become obsolete, unavailable, or unrepresentative of current practices. The staff prepared a briefing package describing modifications of the standard that may be needed to assure that the test in the standard is conducted with equipment and procedures representative of conditions to which garments currently are exposed. After consideration of the briefing package, the Commission decided to begin a proceeding for amendment of the standard. An advance notice of proposed rulemaking (ANPRM) was published in the Federal Register on September 12, 2002. The staff reviewed public comments and proposed amendments for Commission consideration. On January 12, 2007, the Commission voted to publish a notice of proposed rulemaking (NPRM) in the Federal Register. The comment period closed on May 14, 2007. The staff evaluated the comments and prepared a final rule briefing package for Commission consideration. On February 1, 2008, the Commission voted to approve the final rule amending the standard for the Flammability of Clothing Textiles.
Agency: Consumer Product Safety Commission (CPSC)
Priority: Substantive, Nonsignificant

RIN Status: Previously published in the Unified Agenda
Agenda Stage of Rulemaking: Completed Actions
Major: No
Unfunded Mandates: No
CFR Citation: 16 CFR 1610 (To search for a specific CFR, visit the Code of Federal Regulations.)
Legal Authority: 15 USC 1191, Flammable Fabrics Act
Legal Deadline: None

TIMETABLE

Action	Date	FR Cite
Staff Sent Briefing Package to Commission	06/11/2002 ..	
Commission Decision	08/28/2002 ..	
ANPRM	09/12/2002 ..	67 FR 57770
ANPRM Comment Period End	11/12/2002 ..	
Staff Sends Briefing Package to Commission	11/30/2006 ..	
Commission Decision	12/08/2006 ..	
Draft NPRM to Commission	01/10/2007 ..	
Commission Decision on Draft NPRM	01/12/2007 ..	
NPRM	02/27/2007 ..	72 FR 8843
NPRM Comment Period End	05/14/2007 ..	
Staff Sends Briefing Package to Commission	12/27/2007 ..	
Staff Sends Draft FR Notice with Draft Final Rule to Commission	01/22/2008 ..	
Commission Decision	02/01/2008 ..	
Final Action	03/25/2008 ..	73 FR 15636

Regulatory Flexibility Analysis Required: No
Government Levels Affected: None
Federalism: No
Included in the Regulatory Plan: No
RIN Data Printed in the FR: No
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WHY DOES IT TAKE SO LONG FOR CPSC TO PUBLISH A FINAL RULE?

Question. For seven regulations that CPSC has worked on for the past 4 years—some of which date back to the 1990s—the average length of time from initiation of a regulation to a final rule has been almost 6 years, which is a long time to wait when the public has the potential of being injured or killed by a product. Your own statute states that, with certain exceptions, a rule shall be issued within one year of publication of an advance notice of proposed rulemaking.

How can the length of time between initiation of a rule and finalization of it be accelerated?

Answer. Under its statutes, to issue a final rule, the Commission must prepare thorough responses to substantive public comments (which can lead to the need to conduct complex research and testing) and develop a record to support its findings concerning "unreasonable risk," costs and benefits, the basis for why the rule is the "least burdensome alternative," and the inadequacy of any voluntary standards addressing the risk. The findings must be sufficiently robust to withstand judicial challenge, generally against a "substantial evidence" review standard.

Additionally, in rulemakings under the Consumer Product Safety Act or the Federal Hazardous Substances Act that address chronic risks of cancer, birth defects or genetic mutations, the Commission is required to appoint a panel of scientific experts from a list of nominees provided by the National Academy of Sciences, allow the panel to deliberate, and receive the panel's expert opinion concerning the potential harm to human health that could result from exposure to the substance, before the rulemaking may commence with an Advance Notice of Proposed Rulemaking (ANPR). Also, of course, loss of quorum can materially impact rulemaking schedules.

In addition to the requirements of the Commission's statutes noted above, there are numerous other federal government-wide statutory requirements and treaty obligations that impose constraints on the rulemaking process and the rate at which it can be accomplished, including the Regulatory Flexibility Act, the Paperwork Reduction Act, the Small Business Regulatory Enforcement Fairness Act, the National

Environmental Policy Act, and public comment period duration requirements under the North American Free Trade Agreement, among others.

All of these statutorily mandated complexities and checks and balances on the Commission's rulemaking authorities and procedures of necessity constrain the rate at which the deliberative process leading to a final rule can be accomplished.

Last year, I submitted a proposal to Congress to make optional the statutory requirement to commence all standard or ban rulemakings with an ANPR, and I am hopeful that this reform will be included in CPSC's reauthorization when it is passed.

A March 2008 report by Public Citizen criticized the CPSC for not completing work on the seven rules that are referred to in your question. The report is grossly misleading, and information on a few of the examples cited by the Public Citizen report follow:

The upholstered furniture rulemaking activity has been exceptionally complex, with many diverse stake holders providing input into the process. Upholstered furniture components include such varied materials as cover fabrics, loose fillings, barriers, wood, plastic and resilient foams. Each reacts differently to open flame and smoldering ignitions. The components interact with each other during a fire depending on the materials involved and the construction and geometry of the product. In some cases, potential solutions that would mitigate open flame ignitions may not address, or could even reduce, the effectiveness of measures addressing smoldering ignitions and vice-versa. Solving these complex fire science problems has been critical to developing an effective standard that complies with the agency's governing statutes. Nonetheless, the CPSC has proposed a new flammability standard for residential upholstered furniture and published it in the Federal Register on March 4, 2008, for public comment. Finalization of this very important rulemaking is one of my, and the Commission's, highest priorities.

The rulemaking on bedclothes (e.g., quilts, blankets, bedspreads) flammability is closely related to the Commission's recently issued rule on open flame ignition of mattresses, a rule that when fully effective is estimated to prevent over 200 deaths each year. As we enforce the new rule that became effective on July 1, 2007, we gain important information that is relevant to bedclothes flammability. Before proceeding with the development of testing methodology and performance requirements related to bedclothes, CPSC staff will need to evaluate this critical data. It should also be noted that, like upholstered furniture, the fabrics and contents of bedclothes vary enormously in the market, and so development of a single flammability standard would be a very difficult and complex undertaking.

The amendments to the Clothing Textile Standard are technical clarification and work was delayed so that CPSC's flammability experts could concentrate on the important mattress flammability standard (referred to above). This work is now complete and a final rule was published on March 25, 2008.

After the CPSC initiated a rulemaking activity on baby bath seats, the voluntary standard was revised so that it was essentially the same as the mandatory requirements proposed by the CPSC. As noted above, the Commission is prohibited from issuing a mandatory rule if there is a voluntary standard in place that adequately addresses the hazard and there is likely to be substantial compliance with that standard. In that regard, staff is monitoring and evaluating the adequacy of the revised standard and will prepare a formal briefing package for Commission consideration as to whether to continue rulemaking. In the interim, CPSC staff participation in the development of revisions to the voluntary standard has been ongoing and significant.

ILLINOIS—LEAD IN KEYCHAINS

Question. It has come to my attention that Illinois Attorney General Lisa Madigan has contacted you about the sale of some keychains in the State of Illinois that far exceeded lead standards through independent testing. One of these keychains resulted in the injury of a 9-month old baby from Decatur, Illinois. Part of the Attorney General's letter raised concerns about CPSC's response to this report of independent testing.

Will you provide me with your response to this injury report?

Have you responded to the Attorney General's letter?

Answer. The keychains were first brought to CPSC's attention by a professor of chemistry whose class conducted testing of these keychains along with a number of children's jewelry items. There are no standards for lead content of keychains, and at that time, CPSC staff focused on the jewelry items, which are subject to a specific enforcement policy, and obtained recalls as appropriate. Like the CPSC, the State of Illinois also considered the keychains a product for adults, but it became aware

of lead exposure caused by one of the keychains given to an infant by its mother. As soon as CPSC staff learned of this exposure, a recall quickly ensued.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Since our toy safety hearing last September, what specific ways have Chinese manufacturing plants changed their operations to ensure toy safety?

What specifically has the Chinese government done to ensure that toys and other consumer products manufactured for export are meeting safety standards?

How would you characterize your agency's relationship with the Chinese government? Has China been willing to work with you?

Answer. During the past year of CPSC outreach to Chinese manufacturers and Chinese government export inspectors, we have detected a shift of attitudes toward adoption of modern, end-to-end best practices to ensure compliance with safety standards. This shift can be seen in toy industry publications, in seminars for manufacturers hosted by the Chinese government, and in recall case reports to the CPSC from the Chinese regulator.

The work plans that were agreed to at the U.S.-Sino Consumer Product Safety Summit held in September 2007 were outcomes of our Memorandum of Understanding (MOU), which established the framework for cooperation. The work plans called for cooperative work in four product categories: toys, lighters, electrical products, and fireworks. Technical experts are now working on exchanges of standards information, training for product testing, and sharing information and best practices in those four product categories.

Since September, CPSC staff has met eight times, either in person or via video conference, with staff of China's General Administration for Quality Supervision, Inspection and Quarantine (AQSIQ) to review recalls and safety issues.

The CPSC has begun a Chinese language service on our web site, where Chinese suppliers and government officials can get the latest information in Chinese (we are translating requirements and posting them) and descriptions in Chinese that link to the full texts of English language requirements.

At CPSC's invitation, product safety officials from the European Union will join us in China during September for a joint outreach program to consumer product exporters. The Chinese government has enthusiastically endorsed this project and has agreed to facilitate access to the appropriate audiences for the compliance outreach seminars.

Regarding Chinese compliance cooperation, first it should be stressed that the CPSC does not rely on the Chinese government to enforce U.S. requirements. The CPSC enforces our requirements with American importers. That said, the Peoples' Republic of China (PRC) offered to use its export quality control system to target Chinese-made products that would be recalled if they entered the United States. We singled out lead paint on toys as a problem and they agreed to take that on.

—The Chinese government investigates recall causes at the factory and mandates specific changes, such as a change of supplier or more frequent testing. It reports those case-specific outcomes to CPSC. The PRC says it has inspected thousands of factories and revoked hundreds of export licenses for product safety violations.

—The PRC has sponsored numerous high-profile standards and compliance seminars aimed at getting the product safety message to Chinese manufacturers. The CPSC participated in one of these in November.

However, nothing the Chinese government promises and no amount of export control inspection can take the place of major systemic changes in Chinese manufacturing. We are working with Chinese suppliers to hasten that change, but it is the U.S. importer that must ensure that its product complies with our laws.

Question. We cannot merely trust the Chinese. What specifically is your agency doing to verify that the Chinese are adhering to the MOU that we have entered into with them? Have the Chinese resisted your efforts to verify their agreements with us?

Answer. CPSC officials are in China frequently meeting with Chinese industry representatives and government officials to witness their implementation of the policies and practices that we have been encouraging. During the past year, CPSC staff participated in training seminars in China for thousands of Chinese suppliers and we have visited several factories. We also work closely with State Department officials in China, who also visit factories and report on product safety issues. We have not experienced resistance to any of our requests for access or cooperation. Notably, when the CPSC requested an immediate visit to the factory producing the recalled

toy "Aqua Dots," we were provided access to the property (which was not sanitized for us) within 24 hours, as well as an opportunity to speak to the toy designer.

Question. Have the number of consumer product recalls of imported items increased or decreased since September 2007?

Have the number of consumer product recalls of imported items from China increased or decreased since September 2007?

Answer. As a result of heightened industry awareness and aggressive enforcement activities by the CPSC, the number of consumer product recalls of imported items has increased since September 2007, relative to earlier years, and specifically, the number of consumer product recalls of imported items from China has increased since that time. It should be noted that the recalled products from China in this time frame were manufactured and exported to the United States before the U.S.-Sino Consumer Product Safety Summit in September 2007.

Question. Frankly, I worry that the Chinese are unwilling or unable to implement productive changes in their manufacturing processes. How are we to be assured that safety standards will be met and that inspectors will monitor production facilities?

Answer. Regarding Chinese cooperation, it must be stressed that the CPSC does not rely on the Chinese government to enforce U.S. requirements. The CPSC enforces our requirements with American companies that import consumer products. This is the essential purpose of CPSC's new Import Safety Initiative. We have already seen that recalls by the CPSC provide a significant economic incentive to promote change in China.

As noted at the hearing, I would welcome funding for a CPSC Regional Product Safety Officer, supported by a Foreign Service National (FSN), to be stationed at the U.S. Embassy in Beijing to cover Asia and to help us coordinate with Chinese authorities—as a first step in a CPSC overseas presence. Since we are beginning to work with Vietnam and other countries in the region, there would be extended benefits to such a presence.

Question. Ms. Nord, I would like to commend you for your new surveillance initiatives and your plan to hire employees to staff your new Import Surveillance Division. Do you think this increased presence is enough to stem the tide of defective imports flowing into the country? In your estimation what more should be done by the CPSC to help protect American consumers?

Answer. The new CPSC presence at U.S. ports-of-entry is an important advance in our efforts to reduce the number of defective products entering the country. However, because of the sheer volume of consumer products imported into the nation annually, port inspection activity alone is not sufficient. That is the reason that the CPSC has implemented a multi-pronged approach to meet this challenge. In addition to increased dialogue and initiatives with China and other nations to encourage systemic change in their manufacturing processes, the CPSC is working with the private sector and reaching out to foreign manufacturers to establish product safety systems as an integral part of their manufacturing process. Additionally, I have requested a number of new enforcement tools, some of which are included in the CPSC Reform Act that is currently awaiting final action by a Senate/House conference committee. For example, I proposed that it be unlawful to fail to furnish a certificate of compliance with a mandatory standard under any statute administered by the CPSC or to issue a false certificate of compliance. As I mentioned at the hearing, this would be an extremely effective enforcement tool for the CPSC, and although this provision was not in the Senate-passed bill, I am hopeful that the final legislation will include it.

Question. With the increased surveillance at the nation's high impact ports, do you expect there to be any "port shopping" of shipping vessels unloading at the docks with a lower federal presence? If so, how do you plan to tackle this problem?

Answer. It is probably inevitable that some unscrupulous importers will try to find ways to bypass CPSC's fulltime presence at certain ports. It is important to recognize, however, that CPSC's field staff can visit any of the 300 U.S. ports-of-entry and sample products at those locations on an as-needed basis. In addition, the CPSC is now a participating agency in the International Trade Data System (ITDS) Automated Commercial Environment (ACE), which will give us much better information with which to target imports.

Question. Commissioner Nord, Wichita and El Dorado happen to be hubs of the largest latex balloon manufacturing operation in America, and I'm very proud that we continue to have this kind of domestic manufacturing presence in Kansas and in the United States.

I understand that the Balloon industry, Pioneer Balloon in particular, voluntarily put cautionary statements on their packaging as early as 1992. They also worked closely and cooperatively with the CPSC to develop standardized cautionary state-

ments for all balloon packages that were implemented in 1994. These efforts have been effective, with fatal incidents associated with balloons dropping dramatically.

As you may know, there is a provision in the CPSC reauthorization legislation that deals with extending the mandate for cautionary statements on a class of products, including balloons, from the labels of those products to advertising, including Internet and Catalog advertising, for these products. These efforts appear to be intended to ensure that consumers who would see the cautionary statement in a brick and mortar store would also be aware of the hazard if they were to buy balloons online.

While the Balloon Industry wants to safeguard consumers as much as they can, they want to make sure they can continue to do business without a huge chilling effect on commerce or on their business-to-business practices. To that end:

By your understanding of the bill, would the provision affect business to business advertising, in catalogues or the Internet? Because balloons are generally sold from manufacturers to distributors and retailers, I want to be sure that this provision would not be misconstrued to affect business-to-business advertising or catalogs that balloon companies send to their distributors that never make it into the hands of consumers?

Answer. As written, section 11 of S. 2663 does not make a distinction between business-to-business advertisements and business-to-consumer advertisements. Rather, it requires an appropriate cautionary statement in any advertisement on the internet or in a catalogue or other distributed material "that provides a direct means of purchase." The provision does not specify who is making the purchase.

Question. While conferees still have work to do on a final bill, if the provision were to become law, would the CPSC work cooperatively with the Balloon Industry in a way that befits previous cooperation so that we can be sure that only consumers who buy online or from a catalog are affected, and that business to business practices can continue as they exist today?

Answer. The CPSC works cooperatively with affected industries to assure that they understand their requirements under the law as it is written by Congress.

QUESTIONS SUBMITTED TO THOMAS H. MOORE

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Numerous states have either passed or are considering passing their own product safety laws. In some cases, the states would be imposing standards, for lead content for example, which are considerably more restrictive than the contemplated federal standards. How does S. 2663 guard against states creating what would in effect become a patchwork of different material content standards across the country?

Answer. It is unclear the extent to which either S. 2663 or the express preemption provisions of the Federal Hazardous Substances Act would sufficiently address this problem. Regardless of the language used in the final version of the federal statute, in all likelihood these issues will ultimately be resolved in the courts by resort to judicial principles concerning preemption.

Question. While S. 2663 defines "children's product" to mean products designed or intended for use by consumers aged seven or younger, certain state statutes have a higher age threshold. How does S. 2663 avoid a situation in which products destined for very young children are subject to the federal standard while products intended for older children face more restrictive material content standards imposed by the states?

Answer. S. 2663 contains no provision which would avoid such a situation.

Question. How does S. 2663 guard against states passing their own children's product safety laws which encompass specific products, such as jewelry, or a broader array of materials than does the federal law, thus, effectively creating special restrictions for products or materials which Congress did not feel compelled to regulate?

Answer. S.2663 contains no provision which would avoid such a situation.

Question. In the State of Washington, a new product safety law will go into effect in July of 2009. Senate bill 2663 will probably not become effective until after that time; likely the end of 2009. Thus, retailers may face a situation in which they are forced to comply with a very restrictive state standard for several months before the new federal standards take effect. How can S. 2663 be modified to avoid this problem?

Answer. This situation is essentially impossible to prevent in the absence of enactment of a federal law addressing the same scope of products and very clearly stating

Congressional intent to preempt the Washington law prior to the effective date of the Washington law.

SUBCOMMITTEE RECESS

Senator DURBIN. The meeting of the subcommittee will stand recessed.

[Whereupon, at 3:46 p.m., Wednesday, April 30, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

WEDNESDAY, MAY 7, 2008

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:02 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Brownback, and Allard.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. WALTER L. LUKKEN, ACTING CHAIRMAN

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. I call to order this meeting of the Senate Appropriations Committee Subcommittee on Financial Services and General Government. The hearing this afternoon will consider funding requests for two Federal regulatory agencies that are part of the jurisdiction of our subcommittee. My colleagues will be joining me a little bit later.

I am pleased to welcome Acting Chairman Walter Lukken of the Commodity Futures Trading Commission (CFTC), and I am told that CFTC Commissioners Mike Dunn—please indicate, Mike, where you are. Mike, good to see you again. Bart Chilton; is Bart here? Bart, thank you for joining us. Jill Sommers, present. Jill, thank you for attending. I also understand that Chairman Chris Cox of the Securities and Exchange Commission, if he's not here—he's enroute.

I'm going to waive the reading of my opening statement in the interest of having more time to ask questions, and ask consent that it be put in the record. Without Senator Brownback's objection, it will be. So, Senator, if you would like to make any kind of an opening statement, you're welcome to.

Senator BROWNBACK. Before I start, Senator Shelby has submitted a statement that he would like to be included in the record.

[The statements follow:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

Good afternoon. I am pleased to welcome you to this hearing to consider the funding requests of two Federal regulatory agencies within the jurisdiction of the Appropriations Subcommittee on Financial Services and General Government.

I welcome my colleagues who have joined me on the dais today and others who may arrive.

I am pleased to welcome Acting Chairman Walter Lukken of the Commodity Futures Trading Commission (CFTC). I also note that CFTC Commissioners Mike Dunn, Bart Chilton, and Jill Sommers are present. Thank you for attending and for your service.

I welcome Chairman Chris Cox of the Securities and Exchange Commission (SEC), and members of his staff. Thank you all for being here.

The CFTC and the SEC enjoy unique histories, hold specialized and independent responsibilities, and take different approaches to markets that serve differing purposes. Yet the CFTC and the SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity in our country. Through their vigilance, the United States is better equipped to compete in today's evolving global marketplace.

As the subcommittee prepares to make difficult funding decisions for the next fiscal year, I look forward to hearing from our witnesses about the particular challenges their respective agencies face in today's tumultuous economic environment. I welcome input on how we can best address those needs.

Before hearing from our panelists, I'd like briefly outline the missions of these agencies and their budget proposals:

First, the CFTC: It is charged with protecting the public and market users from manipulation, fraud, and abusive practices. It is also responsible for promoting open, competitive, and financially sound markets for commodity futures. The CFTC regulates the activities of nearly 70,000 registrants—from sales people to trading advisors to floor traders.

The CFTC helps ensure that the futures markets are equipped to better perform their vital function in the U.S. economy—providing a mechanism for price discovery and a means of offsetting price risks.

The CFTC's oversight and enforcement mission becomes tangible when you consider that futures prices impact what we pay for the basic necessities of our daily lives: Our food, clothing, shelter, fuel in our vehicles, and heat in our homes.

We have witnessed a remarkable transformation in the nature and type of products listed by exchanges since the CFTC was established in 1976. Thirty-two years ago, the vast majority of futures trading occurred in the agricultural sector—cattle, grains and crops, and the proverbial pork bellies.

Today, novel and highly complex financial contracts are emerging, based on such things as foreign currencies, interest rates, Treasury bonds, weather, real estate and economic derivatives, and stock market indices. These now surpass agricultural contracts in trading volume. And the ever-expanding complexities pose ever-demanding challenges as new futures products emerge.

For the CFTC, the President's budget requests funding of $130 million, representing an increase of $18.7 million—a 17 percent hike—over the fiscal year 2008 enacted level of nearly $111.3 million.

Of the $18.7 million in increased funding for next year, $3.2 million is slated for increased compensation and benefit costs for a staff of 465; $13.6 million will be devoted to increased operating costs for information technology modernization, lease of office space, and other services; and $1.9 million will support the salary and expenses of 10 additional full-time staff.

Currently, with the $111.3 million provided for fiscal year 2008 (a 14 percent increase over the $98 million in fiscal year 2007), CFTC is beginning an intensive hiring process to boost staffing from 447 up to 465 and is making some initial investments to upgrade its information technology to keep pace with the rapidly-evolving technology-driven futures markets.

In the past decade, trading volume has increased more than ten-fold—reaching well over 3 billion trades in 2007, and actively traded contracts have quintupled—from 258 in 1997 to 1,540 in 2007. CFTC oversees $4.2 trillion of daily trades. But despite this phenomenal surge in activity, staffing levels have not kept pace, and in fact, have dropped 21 percent. As I pledged last year, I am committed to addressing this resource deficiency.

I also understand that various components of the CFTC reauthorization, included as part of the farm bill, would impose new responsibilities for the CFTC. Among these elements are regulation of energy derivatives markets and increased penalty authorities for market manipulation violations, which may require additional resources not contemplated in the fiscal year 2009 request.

I look forward to hearing more about CFTC's budgetary needs today, and the opportunity to discuss with Chairman Lukken a variety of issues, including the oversight and regulatory challenges and opportunities presented by rising commodity prices, particularly for agricultural items and oil.

Turning to the SEC, its three-prong mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

The SEC is responsible for overseeing more than 12,000 publicly traded companies, over 10,000 investment advisers that manage more than $38 trillion in assets, nearly 1,000 fund complexes, 6,000 broker dealers with 172,000 branches, and close to $44 trillion worth of trading conducted each year on America's stock and option exchanges.

The strength of the American economy and our financial markets depends on investors' confidence in the financial disclosures and statements released by publicly traded companies. Investors expect the SEC to be the vigilant "cop on the beat." This subcommittee wants to make certain that the SEC has the necessary resources to effectively fulfill its obligatory singular mission: protecting shareholders.

Crucial to the SEC's effectiveness is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions for violations of the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information. Serious, thoughtful questions have been raised about whether the proposed enforcement budget is adequate to keep pace with the growing demands.

The SEC's budget request for fiscal year 2009 totals $913 million, a slight $7 million (0.8 percent) increase over the agency's fiscal year 2008 enacted level of $906 million. Part of the $913 million will be provided through $42 million of prior year balances, resulting in an appropriated level of $871 million. These funds are offset by registration and transaction fees. The fiscal year 2009 budget would fund 3,409 permanent staff, a reduction of 94 staff (a 2.7 percent cut) below the SEC's fiscal year 2008 level.

What is troubling about the paltry increase is that it is insufficient to sustain the agency's salary needs at SEC's authorized personnel level and will actually require cutting nearly 100 staff. This reduction of personnel comes at a time when developments and trends in the market call for more, not less, vigilance to protect investors. Resources devoted to enforcement are declining in both dollar terms and proportionality.

I am concerned this bare-bones budget will hinder the SEC's ability to accomplish its mission. I look forward to exploring this topic more fully with Chairman Cox. In addition, I also plan to delve into other issues including the recent SEC–CFTC Memorandum of Understanding, Sudan divestment disclosure, SEC's role with subprime mortgage markets, expediting Fair Fund disbursements to investor-victims, plans for greater oversight of credit rating agencies, and how availability of interactive data is simplifying investor understanding and access to corporate filings and financial information.

I look forward to hearing from our witnesses about the resources they require to keep pace with change and achieve success in a 21st century world, while responsibly managing taxpayer dollars.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Chairman Cox, in your testimony today you state your support for providing dedicating funding for the SEC's Consolidated Supervised Entities (CSE) program. However, this program has never been explicitly authorized by Congress. Rather, it was created by the SEC. Unlike the Fed's regulation of bank holding companies and the OTS's regulation of thrift holding companies, the SEC's regulation of investment bank holding companies under the CSE program is not authorized by statute. The CSE program is entirely the SEC's creation.

Normally, Congress is responsible for making policy, while the SEC implements that policy. In this case, however, the SEC decided that the CSE program was needed and then took it upon itself to create the program. Before the SEC now decides that a CSE program needs dedicated funding, I believe the SEC needs to take a step back and let Congress decide how investment banks should be regulated.

STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. I appreciate your way and means of doing this, and I'm going to do similarly because I've got a lot of questions.

I would like to, though, point out two things very quickly if I could. First, welcome, Chairman Lukken. I appreciate you being

here. And Securities and Exchange Commission (SEC) Chairman Cox is on his way.

We put these in the record last week at the Joint Economic Committee on ending stocks of wheat and rice. I think it's important to get some factual basis out there. We are at a 27-year low on ending stocks of wheat, I believe. We had a terrible crop last year in the Midwest. You guys don't grow any wheat, but we do, and we didn't grow much last year. And then they didn't in Australia and a number of other places. A similar thing happened on the rice markets as well.

But you can look at other markets that didn't have much of a problem, and yet you've seen this huge rise in prices. I want you particularly to address some of that if you would, because it strikes me that we do have people taking resources and putting them into commodities which drives up some commodities, not based on the fundamentals. There are crop movements that are based on the fundamentals; there are some that are not based on it.

I really hope we can look at that particular issue and the potential manipulation of the market by large hedge funds or index funds, of taking money that they would normally put in other places, maybe even put it in commercial real estate, but with the declining value of the dollar shifting into the commodity markets, and then driving up those market prices above what the fundamental would support. I want to ask you what you anticipate doing to try to address that issue.

Mr. Chairman, thanks for the hearing.

Senator DURBIN. Thanks.

Chairman Lukken, your opening statement. We'll put whatever you like officially in the record and invite you now to give us a few minutes of the introduction to your statement.

SUMMARY STATEMENT OF WALTER L. LUKKEN

Mr. LUKKEN. Thank you, Mr. Chairman and other Senators of the subcommittee. I am pleased to be here to testify on behalf of the Commodity Futures Trading Commission. The CFTC is the agency charged with overseeing and regulating the U.S. commodity futures and options markets. These markets play a critical role in the U.S. economy by providing important risk management tools for market participants. The futures markets also serve to discover prices that accurately reflect supply, demand, and other economic factors.

These are extraordinary times for our markets, with commodity futures prices at unprecedented levels. In the last 3 months the agricultural staples of wheat, corn, soybeans, rice, and oats have hit all-time highs. We've also witnessed record prices in crude oil, gasoline, and other related energy products. Broadly speaking, the falling dollar, strong demand from the emerging world economies, global political unrest, detrimental weather, and ethanol mandates have driven up commodity futures prices across the board.

On top of these trends, the emergence of the subprime crisis last summer led investors to increasingly seek portfolio exposure in commodity futures. As the Federal regulator of these products, the CFTC is closely monitoring these growing markets to ensure they are working properly for farmers, investors, and consumers.

To date, CFTC staff analysis indicates that the current higher futures prices generally are not a result of manipulative forces. That said, we continue to probe, investigate, and gather information from the entire marketplace and welcome outside analysis and perspectives so that we can ensure that we have an accurate and full view.

For example, the agency convened an industry agricultural forum 2 weeks ago to have a full public airing of views as to the driving forces in these markets. The comment period for that event ends today and we hope to announce in the near future agency initiatives to address the concerns we heard at that forum.

The CFTC also recently announced the creation of an energy markets advisory committee and scheduled its first meeting for June 10 to review the functioning of the energy markets.

Despite this tumultuous time in our markets, the agency continues to make advancements on important policy initiatives. Last fall, the Commission delivered an extensive report to Congress recommending additional authorities for the agency in overseeing exempt energy trading. Through bipartisan efforts, these recommendations became a part of the CFTC reauthorization bill, which is contained in the farm bill conference report. The enactment of that legislation will improve our oversight of the energy markets with the addition of new authorities at the agency. The President's fiscal year 2009 budget does not take into account these new powers.

The U.S. futures and options markets of today bear little resemblance to the industry of 1976, the Commission's first year of operation, in terms of complexity, globalization, volume, and economic importance. Yet, staff resources and operating funds over time have not kept pace.

Figure 1 on the monitor shows the growth in trading volume on the U.S. futures exchanges from 1996 to present. Trading volume has increased sixfold during the last decade, while at the same time Commission staffing levels have fallen to 447 full-time employees. That's 50 fewer staff today than the agency had 30 years ago.

Figure 2 lists many of the different components of the futures industry. As you can see from the chart, the growth of these categories from 1976 to present is stunning. For instance, total contract volume has increased more than 8,000 percent in 30 years, compared to CFTC's staffing and overhead expenses, which have decreased 12 percent and 5 percent respectively.

On behalf of the entire Commission, I would like to express my appreciation for the support provided to the CFTC in the fiscal year 2008 budget. The $111 million appropriated by Congress for the current calendar year is already being put to good use to address critical needs in two major areas: personnel and technology. That focus will continue with the fiscal year 2009 budget.

The Commission employs highly trained individuals who work within three program divisions: market oversight; clearing and intermediary oversight; and enforcement. The Division of Market Oversight ensures that the markets are operating efficiently and free from manipulation and fraud. The Commission's staff economists utilize the Commission's Large Trader Reporting System and

one of the Commission's main technology systems, the Integrated Surveillance System (ISS), to detect and deter market manipulation. As you can see in figure 3, the current atmosphere of rising futures prices across a wide range of products makes these anti-manipulation efforts ever the more important.

The Division of Clearing and Intermediary Oversight ensures the financial integrity of the futures industry as a whole. The amount of funds handled by clearinghouses has increased significantly of late. During this time, all exchanges have experienced record settlements, including one day in January 2008 in which the Chicago Mercantile Exchange cleared and settled more than $12 billion worth of transactions in 1 day, nearly six times its normal load. Despite these spikes in cash flow, the clearing system has worked well.

When a manipulation or fraud occurs in the futures markets, it is the job of the Enforcement Division to prosecute the offenders. Since the collapse of Enron, CFTC has brought 39 cases involving energy markets and charged 64 entities or persons with manipulation, attempted manipulation, and false reporting. The collective civil monetary penalties levied in these energy market enforcement cases has exceeded $444 million.

Unfortunately, these programs have felt the effects of turnover at the agency. The Commission lost 58 experienced employees in fiscal year 2006, 49 in 2007, and 15 in 2008. Replenishing these losses is critical if this agency is to continue to meet its responsibilities in overseeing the futures markets.

The fiscal year 2009 President's budget request, as seen in figure 5, is an appropriation of $130 million and 475 full-time staff, an increase of approximately $18.7 million and 10 staff over the fiscal year 2008 appropriation. Key changes in the fiscal year 2009 budget are: $3.2 million to provide increased compensation and benefits for current employees; $1.9 million to provide for salary and expenses of 10 additional full-time employees. This increase, although modest, will allow us to build on current key hiring efforts. And $13.6 million to provide for increased operating costs for technology modernization, office space, and all other services.

In fiscal year 2009, the requested increased funding will continue to target technology upgrades and staffing increases. It would permit the Commission to improve existing critical technology systems, such as the ISS and E-Law systems. The funds requested would also permit the development of the new Trade Surveillance System, or TSS. Soon, with these investments, we will have the capability to more quickly monitor and analyze traders' intraday trading activity.

In conclusion, I am very proud of the agency and our highly skilled staff. Every day they carry out the agency's mission of protecting the public and market users from manipulation, fraud, and abusive practices. If the futures markets fail to work properly, all Americans are impacted. Accordingly, it is critical that the CFTC have sufficient resources to hire and maintain skilled talent as well as to provide a steady stream of technology investment commensurate with the agency's expanding and evolving global mission.

PREPARED STATEMENT

Thank you for this opportunity to appear today and I welcome any questions.

[The statement follows:]

PREPARED STATEMENT OF WALTER L. LUKKEN

Thank you, Mr. Chairman and members of the subcommittee. I am pleased to be here to testify before you on behalf of the Commodity Futures Trading Commission.

BACKGROUND AND CURRENT MARKET EVENTS

The CFTC is the agency charged with overseeing and regulating the U.S. commodity futures and options markets. These markets play a critical role in the U.S. economy by providing risk management tools that producers, distributors, and commercial users of commodities use to protect themselves from unpredictable price changes. The futures markets also play a price discovery role as participants in related cash and over-the-counter markets look to futures markets to discover prices that accurately reflect information on supply, demand, and other factors.

As you are well aware, these are extraordinary times for our markets with commodity futures prices at unprecedented levels. In the last 3 months, the agricultural staples of wheat, corn, soybeans, rice, and oats have hit all-time highs. We have also witnessed record prices in crude oil, gasoline and other related energy products. Both macro-economic factors as well as micro fundamentals for specific markets are at play in these prices. Broadly speaking, the falling dollar, strong demand from the emerging world economies, Mideast political unrest, detrimental weather and ethanol mandates have driven up commodity futures prices across-the-board.

On top of these trends, the emergence of the sub-prime crisis last summer led investors to increasingly seek portfolio exposure in commodity futures. As the Federal regulator of these products, the CFTC is monitoring these growing markets to ensure they are working properly for farmers, investors, and consumers. To date, CFTC staff analysis indicates that the current higher futures prices are generally not a result of manipulative forces. That said, we continue to gather information from the entire marketplace—and welcome outside analysis and perspectives—so that we can ensure that we have an accurate and full view.

For example, the agency recently convened an agriculture forum 2 weeks ago in which we brought together a diverse group of market participants to have a full airing of views and opinions as to the driving forces in these markets. The comment period for that event ends today and we hope to announce in the near future agency initiatives to address the concerns we heard at the forum. The CFTC also recently announced the creation of an Energy Markets Advisory Committee and named the public members of the Committee just last week. Our first meeting is scheduled for June 10th to look at issues related to the energy markets and the CFTC's role in these markets under the Commodity Exchange Act. I am confident that these public forums will benefit our ability to make informed decisions as we strive to improve our oversight of these important markets.

Despite this tumultuous time in our markets, the agency continues to make advancements on several important policy initiatives. Last September, the Commission held a public hearing on the regulation of exempt markets, resulting in an extensive Report to Congress recommending additional authorities for the agency in overseeing this type of trading. Through bipartisan efforts, these recommendations became a part of the CFTC's reauthorization legislation, which is contained in the Farm Bill conference report now being debated. The enactment of that legislation will mean increased responsibilities for the agency—and accordingly, will mean a need for additional CFTC staff to carry out the new authorities. The President's fiscal year 2009 budget for the $130 million funding level does not take into account the new authorities included in the Farm Bill. The legislation would also raise penalties for market manipulation violations and close a legal loophole that has developed due to adverse court decisions that are hindering the CFTC's efforts to combat retail off-exchange foreign currency fraud.

The CFTC has also worked to strengthen its relationship with the Securities and Exchange Commission (SEC) over the last year, given our shared responsibilities over certain products that affect the regulatory interests of both agencies. In March, our respective agencies entered into a memorandum of understanding (MOU) that will help the agencies share information as well as coordinate our review of novel derivative products that have attributes of both securities and futures. Two Chicago exchanges, the Chicago Board Options Exchange and OneChicago, are the first

beneficiaries of this new framework as both seek to list for trading derivative products based on gold ETF products.

Last year was busy on the enforcement front as well with the agency assessing record penalties against those seeking to manipulate the markets and defraud the public, culminating in the CFTC and Department of Justice reaching a record settlement against British Petroleum for manipulating the propane market. I am confident that the CFTC's dedicated staff will continue this productive effort in the coming year.

EVOLUTION OF THE MARKETS

Congress created the CFTC in 1974 as an independent agency. The CFTC's primary mission under our governing statute, the Commodity Exchange Act, is to ensure that the commodity futures and options markets operate in an open and competitive manner, free of price distortions. In December 2000, Congress reauthorized the Commission with passage of the Commodity Futures Modernization Act of 2000 (CFMA). This landmark legislation established a flexible, principles-based regulatory regime. Today, the CFTC is the only U.S. principles-based financial regulator. This flexible approach has allowed the regulated futures industry to flourish. The same flexibility also allows alert and responsive oversight by the CFTC to fulfill the agency's mission.

The U.S. futures and options markets of today bear little resemblance to the industry of 1976 in terms of complexity, globalization, volume, and economic importance—and these differences will continue in fiscal year 2009. Yet, staff resources and operating funds over time have not kept pace.

For example, Figure 1 shows the growth in trading volume on U.S. futures exchanges from 1996 to present. Trading volume has increased six-fold during the last decade, while at the same time, Commission staffing levels have fallen to 447 full-time employees. That's 50 fewer staff today than the agency had 30 years ago in 1976—the Commission's first year of operation.

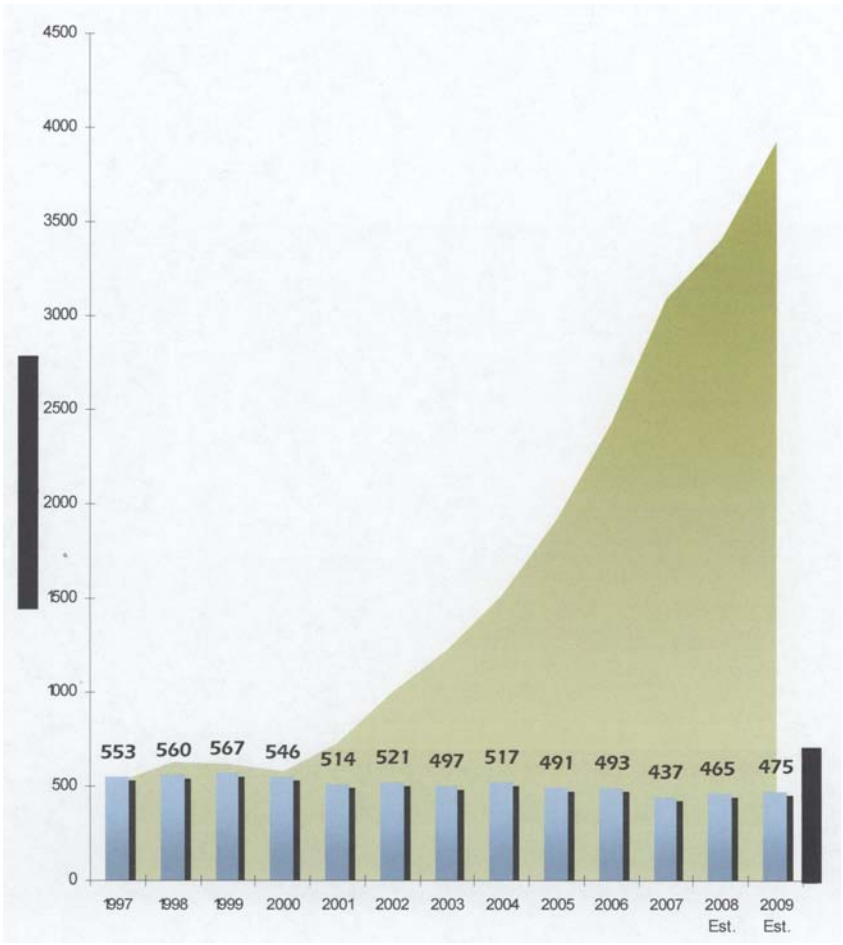


FIGURE 1.—*Growth in Volume of Futures & Option Contracts Traded & FTEs.*

Figure 2 lists the many different components of the futures industry, including the number of contracts traded, the volume of trading, the number of futures industry participants, the number of exchanges and other trading facilities, and the overall notional value of these markets.

Indicator	1976	2007	Percent change
CFTC Staff	497	437	–12
Overhead Expenses as a Percentage of Budget	34	29	–5
Total Contract Volume	37M	3.085B	+8,238
Types of Contracts Traded	66	1,365	+1,968
Commodity Trading Advisors	447	2,601	+482
Commodity Pool Operators	544	1,416	+160
Floor Brokers	2,591	8,038	+210
Associated Persons (Sales Persons)	25,579	53,844	+110
CFTC—Regulated Exchanges	10	12	+20
CFTC—Registered Clearing Organizations	.....	11	([1])
Exempt Boards of Trade	.....	9	([1])
Exempt Commercial Markets	.....	20	([1])
Notional Value of Contracts Traded (Per Day)	$4B	[2] $4.78T	119,400
Customer Funds in FCM Accounts	$577M	$155B	26,763

[1] Not available.
[2] Estimate.

FIGURE 2.—*Indicators of Industry Growth.*

As you can see from the chart, the growth in these categories from 1976 to present is stunning—with percentage increases in the triple, quadruple, and quintuple digits. For instance, total contract volume has increased more than 8,000 percent in 30 years. Contrast that with the CFTC staffing and overhead expenses over time, which have decreased –12 percent and –5 percent, respectively. Looking at the growth in all sectors, it's clear that CFTC is doing a lot more with a lot less.

FISCAL YEAR 2008 BUDGET

On behalf of the entire Commission, I would like to express my appreciation for the support provided to the CFTC in the fiscal year 2008 budget. The $111 million appropriated by Congress for the current calendar year was the first substantial increase for the Commission in recent years and is already being put to good use. It is important to explain how the CFTC is using the fiscal year 2008 funding to address critical needs in two major areas—experienced professionals and a modern technology infrastructure—because the fiscal year 2009 funding will build on that foundation.

Additional Staff Hires

The Commission is implementing an intensive hiring program for the first time since October 2005. This program seeks to fill the loss of experienced, long-time Commission employees, as well as address new skill sets required by the rapidly evolving industry we regulate. The Commission employs highly-trained, expert staff who works within three major program divisions—Market Oversight, Clearing and Intermediary Oversight, and Enforcement. These divisions are complemented and supported by the Offices of the Executive Director, General Counsel, Chief Economist, International Affairs, and External Affairs.

The Division of Market Oversight ensures that the markets are operating efficiently and without manipulation and fraud. One of the keys to Market Oversight is market surveillance. The Commission's staff economists utilize the Commission's large trader reporting system and one of the Commission's main technology systems, the Integrated Surveillance System (ISS), to detect and deter market manipulation and disruption. As you can see in Figure 3, the current atmosphere of rising futures prices across a wide range of products makes these anti-manipulation efforts all the more important.

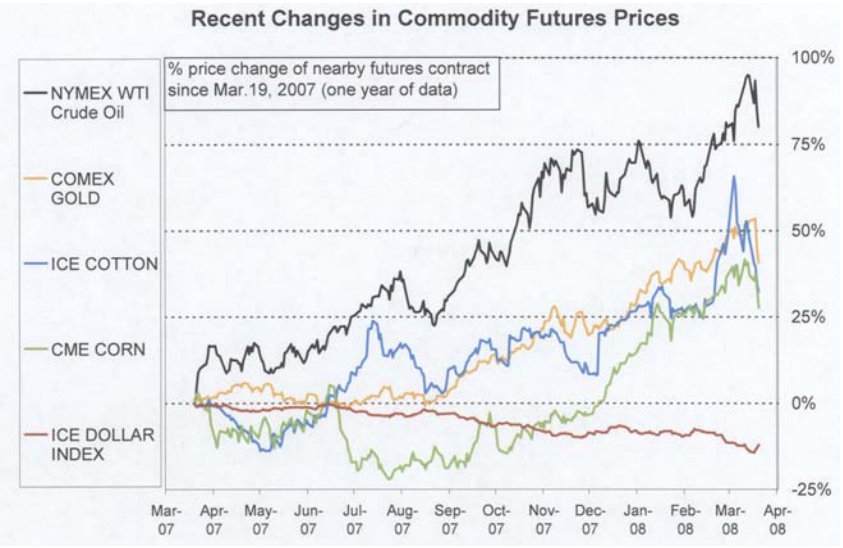


FIGURE 3.—*Recent Commodity Price Changes by Percent Change.*

The Division of Clearing and Intermediary Oversight ensures the financial integrity of the futures industry as a whole. Futures and options trading on U.S. contract markets increased by approximately 27 percent in 2007 over the prior year and remains at consistently high levels. Not only has the volume of trading increased and the futures prices of some commodities increased to record levels, the amount of funds handled by the clearing houses has increased as well. In this regard, all exchanges have experienced record settlements during this time period, including one day in January 2008 in which the Chicago Mercantile Exchange cleared and settled more than $12 billion of transactions—nearly six times its normal load. Despite these spikes in cash flow, the clearing system has worked extraordinarily well. Nevertheless, with the rising need for risk management by businesses and the rising importance of futures markets to the Nation's economy, the Commission's financial integrity programs must be continually strengthened. A key component of the Commission's financial integrity program is the required segregation of all customer funds from those funds of Futures Commission Merchants (FCM). As shown in Figure 4, the level of required segregated customer funds has more than doubled since the end of 2000.

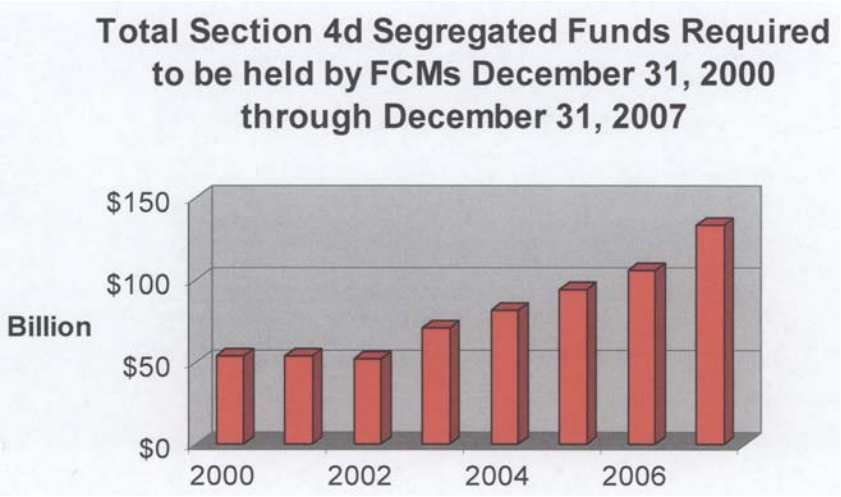


FIGURE 4.—*Segregated Funds Required.*

When a manipulation or fraud occurs in the marketplace, it is the job of the Enforcement Division to gather information, build a case and prosecute the offenders. In the foreign currency or FOREX markets, the CFTC has filed 98 cases involving 374 entities or persons with more than $562 million in civil monetary penalties levied and more than $453 million in restitution awarded. Since the collapse of Enron, CFTC has brought 39 cases involving energy markets and charged 64 entities or persons with manipulation, attempted manipulation, and/or false price reporting. The collective civil monetary penalties levied in these energy market enforcement actions exceed $444 million.

As our financial markets become more complex, global, and interwoven, the Commission is increasingly called upon to co-ordinate and co-operate with other agencies domestically and world wide. Internationally, these activities involve the Commission's participation in multilateral bodies, such as the International Organization of Securities Commissions (IOSCO), as we strive to raise global regulatory standards. This is complemented with specific bilateral information sharing arrangements with other nations as we try to coordinate our enforcement and oversight efforts. Domestically, the Commission staff works with several Federal and State agencies, including USDA, FERC, and DOJ, to harmonize our mutual regulatory efforts. The Commission recently signed an MOU with the SEC to further co-ordinate our efforts, given the additional convergence of the futures and equities markets. In addition, our agency has an information sharing MOU with FERC to enhance cooperation in the policing of the energy markets.

All of these important responsibilities and priorities require qualified personnel in their execution. Unfortunately, recent turnover at the agency has been significant. Throughout the agency and its divisions, the Commission lost 58 experienced employees in fiscal year 2006, 49 in fiscal year 2007 and 15 to date in fiscal year 2008. The Commission currently has 447 full-time employees onboard and with the recent increased funding, we are actively recruiting toward a target of 465 FTEs for fiscal year 2008. Such personnel additions are critical if this agency is to continue to meet its responsibilities in overseeing the futures markets.

Technology Investments

The other focus of the fiscal year 2008 budget allocation is technology. The CFTC primarily uses technology in the surveillance of the markets and the monitoring of the financial integrity of the clearing organizations and firms. The Commission's fiscal year 2008 appropriation enables the agency to undertake a long-delayed modernization of capital investments in Information Technology (IT) software and hardware, such as computers, servers, routers, switches and other critical communications components. The modernization of our surveillance systems will pay off with enhanced transparency and detection tools for the oversight of our markets.

The CFTC receives and analyzes millions of data points everyday that come in from the exchanges and firms, which allow us to monitor the marketplace. Once aggregate position levels are determined, CFTC staff not only monitors daily positions of all large traders, but also has the ability to analyze the minute-by-minute trades of these market participants, including hedge funds and other speculators, during times when there is a heightened risk of manipulation. To do this job, the CFTC's market surveillance staff uses its ISS system to organize and group the information into meaningful categories.

With the exponential growth of these global electronic markets, the CFTC must continue to devote significant portions of its budget to technology in order to stay on top of this sector. This year the agency will increase its technology budget by almost 37 percent with the hope of almost doubling the overall technology budget by fiscal year 2009. These resources will be primarily used to enhance the agency's surveillance tools—making these programs faster, more functional and better able to detect wrongful activities across markets and jurisdictional borders.

Clearly, technology and personnel investments are keys to the agency's success and the fiscal year 2009 budget builds on the foundation that has been enhanced this year. I am grateful for the administration's and appropriators' recognition of the need for increased funding for our agency in these two key areas.

FISCAL YEAR 2009 BUDGET

The fiscal year 2009 President's budget request, as seen in Figure 5, is for an appropriation of $130 million and 475 full-time staff, an increase of approximately $18.7 million and 10 staff over the fiscal year 2008 appropriation.

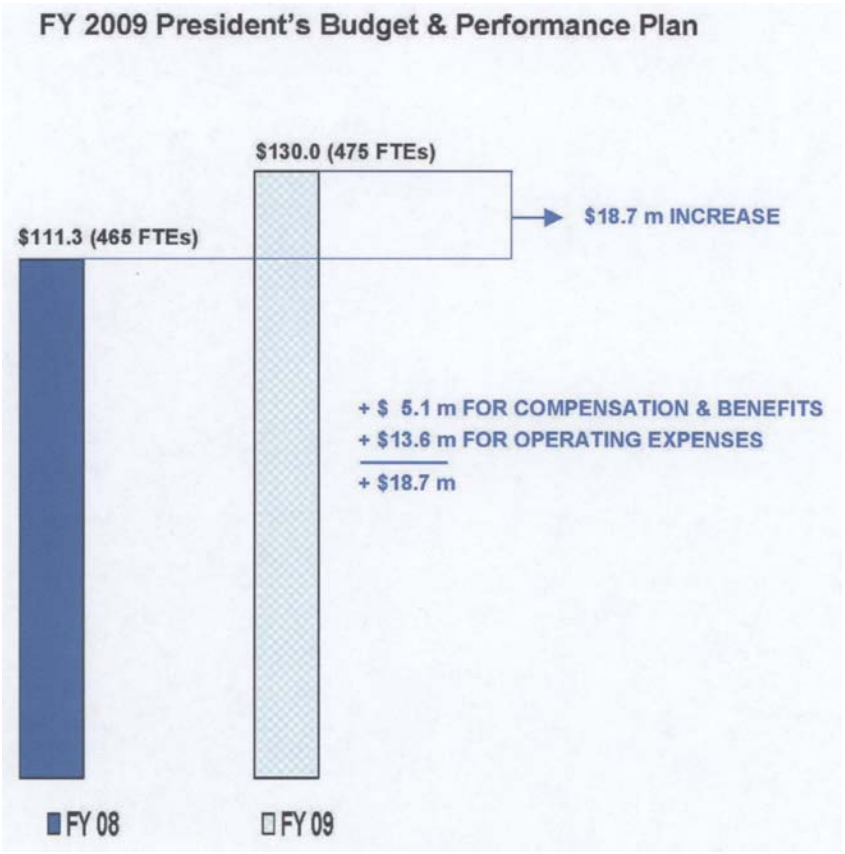


FIGURE 5.—*Fiscal Year 2009 Budget Request Provides for an Increase of $18.7 Million and Additional 10 FTEs.*

Compared to the fiscal year 2008 appropriation, key changes in the fiscal year 2009 budget are:

—$3.2 million to provide for increased compensation and benefit costs for a staff of 465 full-time employees;

—$1.9 million to provide for salary and expenses of 10 additional full-time employees. This portion of the budget also includes $200,000 to establish a student loan program that is designed to help with retention and recruitment of young, qualified professionals. The agency has not had the resources in previous years to be able to support this program and we're pleased to have this program planned for in our budget.

—$13.6 million to provide for increased operating costs for information technology modernization, lease of office space, and all other services.

This funding increase provides the Commission with the financial wherewithal to build on the fiscal year 2008 investments by continuing to hire additional staff and make critical investments in technology.

Additional Staff Hires

For fiscal year 2009 the Commission is requesting ten additional positions. This increase—although modest compared to industry growth—will allow us to build on the hiring we are undertaking as a result of the fiscal year 2008 appropriation. The ten positions requested for fiscal year 2009 are spread throughout the Commission because our needs cut across all of our responsibilities. For example, in the Division of Market Oversight, we will allocate an additional surveillance economist to focus

principally on the complex issues and changing practices in the energy cash and derivatives market. In the Division of Clearing and Intermediary Oversight, we will allocate two additional staff to enhance the expanding financial and risk surveillance functions. In the Enforcement program, two additional staff will focus mainly on allegations of manipulation, trade practice violations, and false reporting, but the additional staff will also enhance our ability to address a wide range of violations of Federal commodities law. One additional staff is planned for the Office of the Chief Economist to conduct market research and analysis commensurate with the growth in new types of exchanges, new trading execution methods, and the role of speculators in our markets. For the Office of Proceedings, we are requesting one addition position to fill the long vacant directorship. For the Office of General Counsel, we are seeking one additional position to replace a loss in expertise among senior staff in areas such as bankruptcy and anti-trust law. Finally, in the Office of Information Technology, we are requesting two additional positions to enhance in-house expertise to assist the major program Divisions in monitoring, auditing, and investigating increasingly sophisticated technologically driven markets.

Technology Investments

In fiscal year 2009, additional funding would permit the Commission to upgrade telecommunications systems and to expand and improve existing critical systems, such as the Integrated Surveillance System and eLaw. Also in fiscal year 2009, funds requested would permit continued development of the new Trade Surveillance System (TSS), which will be used for trade practice surveillance on all exchanges, including new and emerging electronic exchanges. TSS will use state-of-the-art, commercially available software to enhance both intra-exchange and inter-exchange trade practice surveillance. We can now obtain and analyze the trading activity of our large traders in a mere fraction of the time it used to take—minutes instead of days. Soon, with these investments, we will have the capability to monitor and analyze even more quickly and efficiently a trader's intraday trading activity.

The Commission's ability to fulfill its mission depends on the collection, analysis, communication and presentation of information in forms useful to Commission employees, the regulated industry, other Federal, State, and international agencies, the Congress, and the American public. The resources allocated in fiscal year 2008 and fiscal year 2009 to Information Technology will permit a secure modern information technology infrastructure and the development of a Document Management System to modernize, centralize and automate the management of the Commission's information resources. These comprehensive enhancements will enable the Commission to serve these stakeholders effectively.

The fiscal year 2009 budget, if approved, will largely enable completion of the CFTC's technology modernization initiative—barring unforeseen industry developments or new statutory requirements. The Commission is making a concerted effort to use commercial best practices in developing and maintaining its IT systems and ensuring that our IT staff is focused on increasing efficiency and controlling costs.

All of the technology improvements have one commonality; they help increase the availability of one of our most critical resources—time. That is, technology allows our growing staff to become more productive by spending additional time on qualitative analysis rather than quantitative processing and compilation.

CONCLUSION

I am very proud of the agency and our highly-skilled staff. Everyday, they carry out the agency's mission of protecting the public and market users from manipulation, fraud, and abusive practices and promoting open, competitive and financially sound markets. If the futures markets fail to work properly, all Americans are impacted.

When looking at the increased volume of activity across all areas of the CFTC mission and the scope of the industry changes, the resulting increase in specialized workload is demonstrable. Accordingly, it is critical that the CFTC have sufficient resources to hire and maintain skilled talent, as well as provide a steady stream of technology investment commensurate with the agency's expanding and evolving global mission.

Thank you for the opportunity to appear before you today on behalf of the CFTC. I would be happy to answer any questions you may have.

ADEQUATE STAFFING TO MEET VOLUME INCREASES

Senator DURBIN. Chairman Lukken, your graphs tell the story about a dramatic increase in trading that you are responsible to

oversee. As I understand it, if you're able to replace employees that have left, the President's new budget request will give you an additional 10 employees over the 465 that you're targeting. I can't imagine that gets close to matching the volume increase that this agency faces in terms of the markets that you supervise. Does it?

Mr. LUKKEN. Well, our fighting weight as an agency historically has been in the mid-500s, and we're trying to build up over a series, a period of years, to get to those levels, and we're hopeful to reach that. I think the 10 that we've requested in 2009 is the minimum we need to ensure our responsibilities at the agency. The technology is very important in ensuring that we're productive in those 10 individuals.

So we're looking over a long-term horizon to make sure that we get to where we need to be, but we think 10 is a good start in that venture.

SPECULATION IMPACT ON ENERGY FUTURES

Senator DURBIN. So let me try to be more specific in the next question about another issue. As I understand your testimony and your agency's responsibility, you look for illegal conduct, market manipulation, evidence of corruption, and obviously do your best to keep transparency and credibility, integrity in the marketplace, and that is an important part of your role.

But you've also initiated several discussions that relate to the overall market and the role it has in our economy as it relates to specific commodities. Now being more specific, when it comes to energy contracts, that's one that's in the news. And there are a lot of people, including some of my colleagues that I respect very much, who think that the speculation and trading in energy futures has driven up the price of oil, for example. One of my colleagues today said he thought that of the $120 a barrel, maybe $30 of it or more was attributable just to speculators driving up the price of the commodity.

There's also a question about margin requirements when it comes to these energy futures.

Let me throw in the third element, of course: global competition. In London, ICE is selling many of these same contracts or contracts similar to them.

That's as soft a pitch as I could throw you on this, but I'd like your feedback on the speculation on this issue.

Mr. LUKKEN. Well, certainly we closely follow the market participants and track what speculators may be doing in our markets. As I mentioned, we receive every day the trade positions of all traders in our markets above a certain threshold. That ensures that we can see what sort of controlling positions they may have as traders on a given market.

Our economists also closely follow fundamentals of those markets to ensure that those types of traders aren't using their positions in order to manipulate or cause some sort of illegal behavior in our markets. So we closely follow that. Like I said, every day we're looking at who the large traders might be and whether they're either themselves or colluding with others to try to manipulate the markets.

Senator DURBIN. Do you think that that's happening now? Do you think that the observation that $20 or $30 on a barrel of oil can be attributed to speculation is a valid observation?

Mr. LUKKEN. Well, I think as far as illegal behavior, where an individual or a set of individuals are trying to manipulate the market, I can say with a high degree of confidence that we are not seeing that. With regard to speculation, we also have controls in place for speculators. Each month as the contract is about to expire, they have to get down to certain positions in agricultural markets and other, energy contracts so that there's a less chance that they may be able to manipulate the markets, and those controls are currently in place.

So between seeing the transparency of the reporting that we receive, plus the controls, the position limits we have in place, we have a high degree of confidence that people are not manipulating the markets.

MARGIN REQUIREMENTS

Senator DURBIN. And what are the margin requirements on these energy contracts?

Mr. LUKKEN. The margin requirements—as you know, in the futures industry, margin is set based on a risk modeling that the exchanges perform, and this is meant to cover a 1-day price move, so that the losers can pay the winners every day, and the markets mark to market at least twice a day. This wrings the risk, credit default risk, out of the marketplace, so that losses can't accumulate over a period of days. So every day everybody starts afresh.

So this has worked very well to——

Senator DURBIN. Is there a margin requirement?

Mr. LUKKEN. For?

Senator DURBIN. Energy futures.

Mr. LUKKEN. Yes, there is. There is to cover a potential 1-day price move. Again, this is based on statistical, historical and statistical evidence of what that might be.

Senator DURBIN. How does that compare with other commodities, the actual margin requirement?

Mr. LUKKEN. It's based on volatility. I'll have to ask our staff whether we can get you figures on percentages. But oil, I think, is sort of middle of the pack as far as volatility compared to some of the other commodities. But we can give you specific numbers.

Senator DURBIN. The last question—I'm sorry to go over a minute, but I didn't get my entire opening statement, so I can have an extra minute here. So if we passed a law calling on you to substantially increase the margin requirements on energy futures, particularly as they relate to crude oil, what impact would that have in your estimation on migration to another marketplace, like ICE in London, as an alternative market to pursue the same type of future?

Mr. LUKKEN. I think there would be migration off exchanges. It would be a tax on a type of trader. These traders—I know that there's a lot of people who have disparaging remarks about speculators, but they do provide liquidity for a lot of these markets and have for years, and that's necessary to make sure that the commer-

cial participants in the markets, the producers, the farmers, and everybody, has a buyer for every seller and a seller for every buyer.

Senator DURBIN. What percentage of those who trade, for example, in these energy commodities actually take possession?

Mr. LUKKEN. Very few. Very few actually ever deliver. The vast majority of the contracts never deliver the physical commodity. The futures markets are not a marketing tool for product. It is a risk management tool and people utilize it as a risk management tool. There has to be delivery as part of the mechanism to ensure that the cash price and the futures price eventually converge, but the truth is that most people get out of these contracts way before delivery ever occurs.

Senator DURBIN. Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman.

MONITORING MARKET FUNDAMENTALS

Years ago when I was a farm broadcaster, I thought I was really smart on these markets, so I speculated a little bit, lost my shirt. My dad would not listen to anything I ever said again from that point. He farms and he said: All right, we're just going to keep it in the bin now; I'm not listening to you any more.

So I know those things move on you. I was long in the wheat futures when the Soviets invaded Afghanistan, if anybody remembers that period, and we lock-limited down the markets for 3 days. I'll never forget it. It was quite an experience for a young man.

You mentioned, though, earlier, Chairman, that your economists track the fundamentals and what the market should be. What should the price of oil be now, according to what your economists are saying?

Mr. LUKKEN. Well, we make sure that the markets are reflecting as best they can and they are functioning efficiently and performing. We can't predict what prices may be. That's the function of a free market.

Senator BROWNBACK. Do you do a range? Do you do a range and say, on these fundamentals, this supply, this demand, there is a range that this price should in normal circumstances trade in? Do you do any historical view of that?

Mr. LUKKEN. We do not.

Senator BROWNBACK. There's been a number of articles out lately thinking that these markets are being driven heavily.

Mr. LUKKEN. We do closely follow what the Department of Energy and the U.S. Department of Agriculture, the numbers that they're putting out, looking at a holistic approach to make sure the fundamentals are supporting the general prices that are being put out by the markets. And if we see——

Senator BROWNBACK. Well then, answer that question: Do the fundamentals support the general prices being put out by this oil market?

Mr. LUKKEN. I think, based on supply and demand that we're seeing—and a lot of people in the markets agree—that yes, the fundamentals do support largely what the prices are at today.

Senator BROWNBACK. So you disagree with what the chairman said, that there's as much as $30 in these markets that's based on speculation?

Mr. LUKKEN. Well, I have not seen that study, so we'd have to look at that. But we have not seen that speculators again are driving—are a major factor in setting these prices.

Senator BROWNBACK. You're familiar, and I'll enter into the record, there's a Barron's article that cites that they believe that they are.

[The information follows:]

[From Barron's, Monday, March 31, 2008]

COMMODITIES: WHO'S BEHIND THE BOOM?

(By Gene Epstein)

China, as everyone knows, is a big force in the extraordinary boom in commodities. Its voracious appetite for everything from corn and wheat to copper and oil has helped push up U.S. commodities prices by some 50 percent over the past 12 months.

But China is by no means the whole story. Speculators—including small investors—are also playing a huge role. Thanks to the proliferation of mutual funds and exchange-traded funds tied to commodities indexes, speculative buying has gone way beyond anything the domestic commodities markets have ever seen. By one estimate, index funds right now account for 40 percent of all bullish bets on commodities. The speculative juices are even more plentiful—nearly 60 percent of bullish positions—if you count the bets placed by traditional commodity "pools."

Here's the problem: The speculators' bullishness may be way overdone, in the process lifting prices far above fair value. If the speculators were to follow the commercial players—the farmers, the food processors, the energy producers and others who trade daily in the physical commodities—they'd be heading for the exits. For right now, the commercial players are betting on price declines more heavily than ever before, says independent analyst Steve Briese.

For example, in the 17 commodities that make up the Continuous Commodity Index, net short positions by the commercials have been running more than 30 percent higher than their previous net-short record, in March 2004.

Briese, author of the recent book The Commitments of Traders Bible and editor of the Website CommitmentsOfTraders.org, was one of the first to recognize that information on the bets made by the commercials could provide rare insights into how the "smart money" views the price outlook. These days, the data suggest, the smart money clearly believes that the market's exuberance has turned irrational.

Indeed, the great commodities bubble started springing its first leaks two weeks ago: Oil, gold and other major commodities posted their steepest weekly drop in half a century. Though prices have since firmed, they could eventually drop 30 percent as speculators retreat. The only real question is when.

It's not easy to size up the influence of the index funds. But based on their known cash commitments in certain commodities, and the commodity indexes their prospectuses say they track, it is possible to estimate the size of their commitments in all commodities they buy. Using this method, analyst Briese (pronounced "breezy") estimates that the index funds hold about $211 billion worth of bets on the buy side in U.S. markets.

Applying a similar method, but with slightly different assumptions for indexes tracked, Bianco Research analyst Greg Blaha puts that figure at $194 billion. Either figure is enough to turn the index funds into the behemoths of the commodity pits, where total bullish positions now stand at $568 billion.

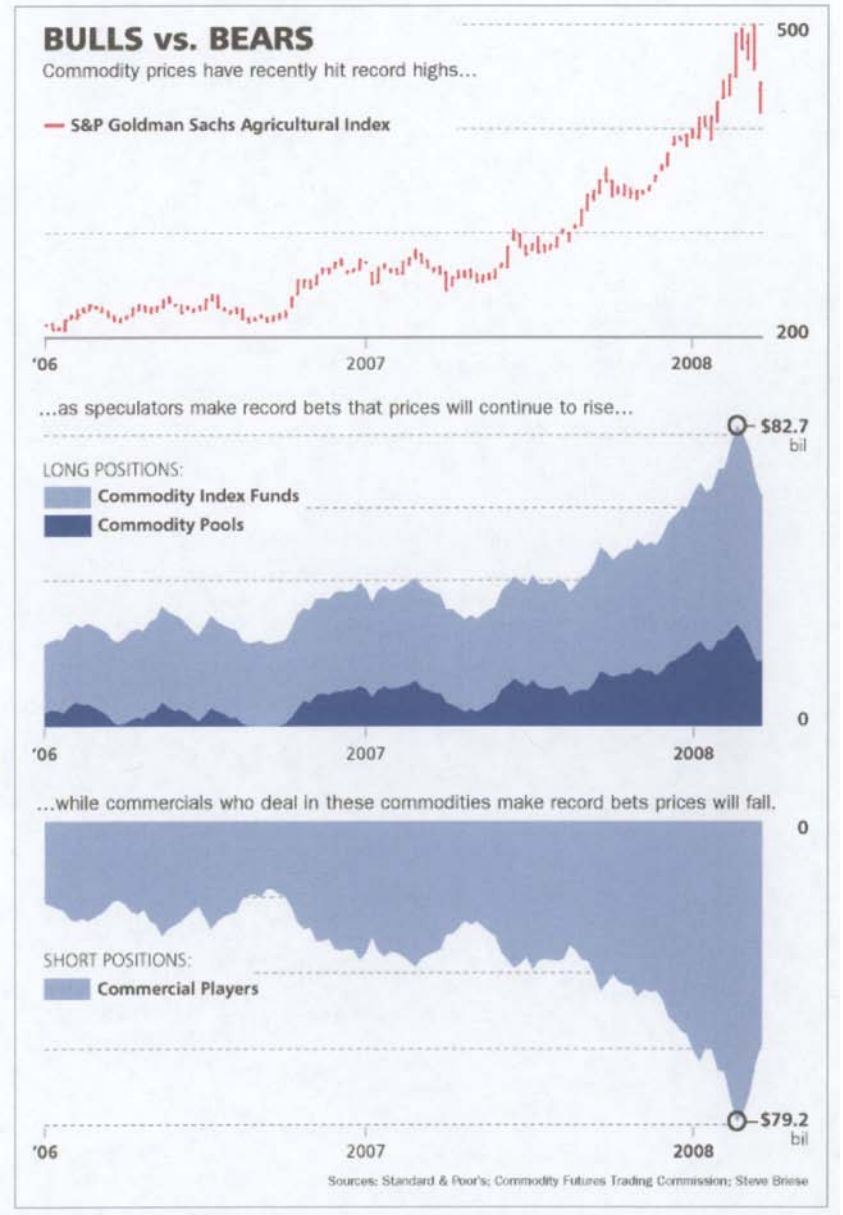
Commodities index funds, which arrived on the scene in the late 1990s, have come into their own in the past several years. The biggest index fund, Pimco Real Return (ticker: PRTNX), has seen its assets swell to $14.3 billion from $8 million since its inception in January 1997.

Index funds offer investors an easy, inexpensive way to gain exposure to a segment of the commodities markets or a broad-based basket of commodities. Result: The funds have drawn many private investors who have never ventured into futures, along with pension funds and other institutional players looking to diversify. But for all the virtues that the funds hold as a way of spreading bets across commodity markets, they take only long, or bullish, positions, avoiding short-selling. In other words, they trade on the naïve and potentially fatal assumption that commodities have the same tendency as stocks to rise over the long run.

That this large, bullishly oriented group of funds is flourishing is partly a result of a regulatory anomaly. In recognition of the fact that the commodity markets are

too small to absorb an excess of speculative dollars, the Commodity Futures Trading Commission, in conjunction with exchanges, imposes position limits on speculators. But the agency has effectively exempted the index funds from position limits.

The dislocations caused by allowing so much money into markets that have limited liquidity is now causing alarm in the trading pits. That, in turn, is prompting the CFTC to call for an industry gathering April 22 at its Washington headquarters "to hear firsthand from participants to ensure that the exchanges are functioning properly." On this and related issues, CFTC Acting Chairman Walter Lukken declined to comment to Barron's.



Unless regulators clamp down, the index funds could become an even bigger force in the markets. In the midst of the recent sell-off, commodity bull Jim Rogers made that very point in an interview with Bloomberg News. Referring to the "over 70,000 mutual funds in the world" compared with the "fewer than 50" that now invest in commodities, he held out the prospect of a speculative bubble that could last for years.

In Rogers' view, the bull market is in the "fourth inning" of a "nine-inning baseball game." To which commodity bear Steve Briese counter-quips, "Maybe, but can't the game be called for a year or two, on account of rain?"

In the organized commodity markets, trading is in futures and options, which are essentially two-way bets on the outlook for prices. For every buyer (a "long") of a future or options contract betting on a price rise, there is a seller (a "short"), taking the other side of the contract by betting on a price decline. Since speculators and commercials as a group can be either short or long, the charts (see the last page) track the net position—longs minus shorts—held by either group. Courtesy of Briese, the charts track net long or short positions in dollars, based on the dollar value of the commodity each futures or options contract covers.

The speculators, now so bullish, are mainly the index funds. To see how their influence on the market has become outsized, just look at how they operate. Nearly $9 out of every $10 of index-fund money is not traded directly on the commodity exchanges, but instead goes through dealers that belong to the International Swaps and Derivatives Association (ISDA). These swaps dealers lay off their speculative risk on the organized commodity markets, while effectively serving as market makers for the index funds. By using the ISDA as a conduit, the index funds get an exemption from position limits that are normally imposed on any other speculator, including the $1 in every $10 of index-fund money that does not go through the swaps dealers.

The purpose of position limits on speculators, which date back to 1936, is clearly stated in the rules: It's to protect these relatively small markets from price distortions. An exemption is offered only to "bona fide hedgers" (not to be confused with "hedge funds"), who take offsetting positions in the physical commodity.

The basic argument put forward by the CFTC for exempting swaps dealers is that they, too, are offsetting other positions—those taken with the index funds.

Position limits on speculators, in some commodities specified by CFTC rules and in others by the exchanges, are generally quite liberal. For example, the position limit on wheat traded on the Chicago Board of Trade is set at 6,500 contracts. At an approximate value of $60,000 worth of wheat per contract, a speculator could command as much as $390 million of wheat and still not exceed the limit.

But at least one index fund that does trade the organized commodity markets directly and must therefore abide by the rules—PowerShares DB Multi-Sector Commodity Trust (DBA)—recently informed investors that it was bumping up against position limits and therefore would change its strategy.

No such information is available from individual swaps dealers. But based on CFTC data on their total position in a commodity like wheat, together with the fact that only four dealers account for 70 percent of all the trading from the ISDA, it is quite clear that if the exemption were ever rescinded, the dealers' trading in these markets would no longer be viable.

Speculators also use the older commodity pools, whose position is likewise tracked on the charts. The pools, open to sophisticated investors, are flexible enough to sell short as well as buy long and are subject to position limits. But since they are generally trend-followers, they will almost always go long in bull markets. Through most of the recent period, then, the pools have been adding to the price distortions caused by the index funds. Add the pools' bets to those of the index funds, and speculative money forms 58 percent of all bullish positions.

To get a further idea of the impact of these speculative bets, Barron's asked Briese to measure them against production in the underlying markets. He calculates that in soybeans, the index funds have effectively bought 36.6 percent of the domestic 2007 crop, and that if you add the commodity pools, the figure climbs to 59.1 percent. In wheat, the figures are even higher—62.3 percent for the index funds alone, and the figure jumps to a whopping 83.6 percent if you add the pools. Betting against them as never before are the commercials, who deal in the physical commodity.

The CFTC provides these figures on index trading for only 10 commodities. Why are such major commodities as crude oil, gold, and copper excluded? The agency's rationale, which even certain insiders question, is that it would be hard to get reliable information on these other commodities from the swaps dealers.

What might finally trigger the bursting of the commodities bubble?

One possible trigger was cited in a Barron's interview with Carl Weinberg of High Frequency Economics, published last week. Weinberg anticipated a break "some time this year" in industrial commodities, including crude oil, copper and natural gas once there is news of "even the slightest slowdown in the Chinese economy," the country whose insatiable demand, together with that of India, has been a rallying cry of the bullish speculators. When industrial commodities prove vulnerable, speculative money could start fleeing agricultural commodities, also.

Société Générale analyst Albert Edwards goes much further. Based on his view that the "Commodity bubble is nonsense on stilts," Edwards holds the "very strong conviction that before the end of this year, commodity prices . . . will be unraveling." He believes the triggering events will be the "unfolding U.S. consumer recession" and likelihood of "negative CPI [consumer price index] inflation rates."

A sudden turnaround in the dollar could be another trigger, notes Briese. By making dollar-denominated commodities ever cheaper in terms of other currencies, the collapsing dollar has been a legitimate bullish factor. "But the buck won't go down forever," Briese argues. "The same cycles that coincided with the dollar's major bottom in 1992 are due to make a low later this year. A rebounding dollar would pinch demand for dollar-denominated commodities."

Alternatively, to borrow a quip from the late humorist Art Buchwald—who once explained that his candidate lost the election owing to "not enough votes"—the bubble could burst from not enough buying. Brokerage houses have been advising their clients to allocate part of their portfolios to commodities, compared with allocations of zero several years ago. Even a shift of five percentage points would have been more than enough to account for the dollars that have fueled the "nonsense on stilts."

But what if the U.S. economy proves more resilient than currently thought, doesn't fall into recession, and instead starts growing again? The resulting rally in the stock market could send the allocation share back to zero and the bubble could burst, not with a bang, but with a whimper.

The CFTC could also prick the bubble by enforcing its own rules. If the agency were to rescind the exemption on position limits given to the index funds (say, on a phased basis, so that the funds could make an orderly retreat), prices would probably fall back to reflect their true supply-demand fundamentals.

Briese's analysis of commercial hedger positions leads him to believe that commodities in general were fully valued in terms of the fundamentals as of early September 2007. Based on the 24-commodity S&P Goldman Sachs Commodity Index, that would mean about a 30 percent collapse from present levels. But, he adds, "Given the tendency for prices to overshoot, commodity values could be cut in half before they stabilize."

Maybe it's time to start listening to the smart money.

LIMITATIONS ON OPEN POSITIONS

Senator BROWNBACK. I would ask you as well: You have limitations on what one individual can control as far as the number of open positions in a commodity; is that correct?

Mr. LUKKEN. That is correct.

Senator BROWNBACK. Does that same limitation apply to a hedge fund?

Mr. LUKKEN. It does.

Senator BROWNBACK. To an index fund? To a hedge fund?

Mr. LUKKEN. Well, a hedge fund is in our terms somebody who is a speculative trader. An index fund is somebody like Goldman Sachs or AIG, which is a fund that brings in passive long-only investments into our markets. We typically call speculators those that are buying and selling over a short-term horizon. These are long-term investments in which pension funds such as CALPERS or retirement funds and endowment funds come into our markets in a buy and hold type strategy.

Senator BROWNBACK. And there is no limitation on the amount of open positions they can maintain?

Mr. LUKKEN. They receive an exemption from us for those position limits.

Senator BROWNBACK. Now, in one article that I read—only long position?

Mr. LUKKEN. Only long.

Senator BROWNBACK. But in one of the articles I read, that they were holding as much as 40 percent of some of the near-term long positions in these index funds.

Mr. LUKKEN. Well, they normally never get into the spot month. They roll before the spot month occurs. So they again are seeking long-term exposure.

But in our analysis—and this is something that was discussed quite a bit at the agricultural forum we held 2 weeks ago—we've seen evidence where the largest percentage of index fund trading is in live cattle right now, about 45 percent of the market, and yet live cattle is down 6 percent, 8 percent on the year. So we have not seen high levels of correlation. In fact, Minneapolis wheat contract has no index fund trading——

INDEX FUNDS IN OIL MARKETS

Senator BROWNBACK. What about oil?

Mr. LUKKEN. Unfortunately, because of the way that index funds enter into the oil markets, we're not able to pull out that data separately. But it's something we're looking into trying to drill down to find out how the index funds enter into those markets.

Senator BROWNBACK. It sure seems like that's one you really ought to be, as you say, no pun intended, drilling down into.

Mr. LUKKEN. Well, it's something we want to look into further, how we can do it. It's a resource question because many of these index funds do a variety of types of trading. They don't separate the two, and so for us to try to find out that type of data, it would be very resource-intensive. But it's something we're interested in finding out.

Senator BROWNBACK. Why wouldn't you want to limit the number of open positions, open long positions, that an index fund could maintain? I mean, it seems to me, and maybe I'm looking at this too simply, but that people are parking money in these areas, which is fine, but you're taking a bunch of product off the market then and you're letting one entity control it, which you would not let an individual do. But an individual runs this fund and so you've got an individual sitting on top of a big hedge fund that's controlling a lot of positions.

Mr. LUKKEN. Yes.

Senator BROWNBACK. I think back to when somebody was trying to capture the silver market two or three decades ago. It seems like you could get very much in the same spot, just only now the name's an index fund rather than an individual, but it's still a person that controls it.

Mr. LUKKEN. Our markets are risk management markets. Financial institutions who are selling these products to pension funds and others have a risk. They have risks that they're trying to offlay in the futures markets. They are exposed to a long or short position when they do sell these products. Our markets try to help them to offset that risk.

That's why I think there's been some discussion of whether we should call them a hedger, such that a producer or a grain elevator

is a hedger. But they are hedging some type of financial risk, and it's been the position of the Commission for 20-plus years to allow them to have that type of an exemption.

But I think this is something that came out in this ag forum and something that we're closely looking at to make sure that we're categorizing them correctly.

I would point out that, even though they are not subject to these position limits, we still see all the positions. We see who they are. The transparency is complete for us. So we're able, if we think they have a position that's going to manipulate the markets, we as regulators can see that. They just don't have hard limits as they do maybe with the position limits. But we certainly can see and exercise judgment on whether they're trying to control the marketplace.

Senator BROWNBACK. It seems to me that you could see where this could happen, where they could drive the market up just by having a big quantity of open positions on long positions. I mean, it just seems, on its face, something that really we ought to be deeply concerned about. I hope you do look at the amount of positions you let them hold, long positions in those months.

Mr. Chairman, thank you for being generous with my time.

Senator DURBIN. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I do have a statement I'd like to put in the record, with unanimous consent to do that.

Senator DURBIN. Without objection.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Durbin and Ranking Member Brownback for holding this hearing to examine the fiscal year 2009 budget requests of the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). I appreciate the opportunity to more closely examine the regulation of our securities and futures markets.

American capital markets are predicated on openness and fairness, and that fairness is only assured though careful, prudent, consistent regulation. The SEC and CFTC are at the heart of the effort to protect market participants and investors and to ensure market integrity.

The financial markets have seen a great deal of growth and evolution during recent years. Regulation is becoming all the more challenging as the agencies must not only adapt to changing times, but try to anticipate future trends. The SEC and CFTC budget requests for fiscal year 2009 are an important part of helping the agencies meet those challenges.

I place a strong emphasis on outcomes, particularly in the area of budgeting. Budgets are not, or at least should not, be simply a sign of how much we like a particular program. Rather, it should be tied to need and the results that are being achieved with past funding.

I am concerned that neither budget before us today strikes the right balance. The CFTC is requesting a very large funding increase, yet according to the PART assessment is demonstrating no results. By contrast, the SEC, at least in some of its programs, has been shown to be effective. We have also heard repeated testimony in the authorizing committee about the need for a stronger SEC presence, yet, this budget actually proposes reduced staffing levels.

I will be eager to hear from the chairmen to see how they square their budget requests with the facts on the table.

Thank you, Mr. Chairman.

Senator ALLARD. Just for the record of this subcommittee, I think if we were ever to look at a place where there is some market control it would be the OPEC countries. Obviously, we're not going to be able to control them, but you know, they produce oil, I'm told,

in Iran for $15 to $17 a barrel. In Saudi Arabia they produce it out of the ground for $1 to $3 a barrel. We're paying $115 a barrel.

I think that has more to do with the OPEC cartel and what they're doing, their markup. I think that's where the real problem is. So I just wanted to make that point for the record.

PROGRAM ASSESSMENT RATING

One thing that you're doing that does concern me in a big way, and that is that I don't see you having a satisfactory score on the PART program. If you refer to the PART program, you understand which program I'm referring to? Well, you need to know about it. The PART program is where the administration measures objectives and results.

You are scored as not making any effort—your score on that is that you haven't done anything to measure results and outcomes. Many of the agencies have. The SEC, which we'll be hearing from, has a good PART score. You have "no results demonstrated."

Why is that?

Mr. LUKKEN. I have to admit, Senator, this is something—I just got handed a note. This is dealing with the enforcement program?

Senator ALLARD. Well, it's "CFTC." That's the way it's listed, I think, on the PART program. How is it listed?

Mr. LUKKEN. "CFTC?"

Senator ALLARD. It's listed as "CFTC" in general, a line item, "CFTC."

Your evaluation comes from the Office of Management and Budget (OMB). As a policymaker, we look at that to see whether the taxpayer dollars or the fees that you're collecting are being put into an efficient and effective program. If we look at yours, where "no results demonstrated," what is this? I mean, it's the CFTC; they're supposed to be a good business. They're not even practicing good business. Most good-managed businesses use management by objectives. That's what we're talking about.

I see from "no results demonstrated," which tells me you're not even bothering to set goals and objectives and trying to reach those. Those are measurable goals and objectives.

If you go onto the Internet on expectmore.gov, enforcement of commodity futures and options, your rating is "not performing, results not demonstrated; the program lacks performance measures that illustrate whether the program meets its overall objectives. The program demonstrates through the existing performance measures that it brings substantive cases in a timely manner. The program is well-designed to meet its objectives and examine the use"—those are the three classifications.

You're classified as "results not demonstrated." So a question I have is, why aren't you doing this?

Mr. LUKKEN. Well, that's something I'll commit to you to look further into. I just got handed a note that we rated 80 out of 100. But this is something——

Senator ALLARD. Well, it's not showing up on expectmore.gov.

Mr. LUKKEN. It's my understanding that we did score, and on the enforcement program I know there was something we were trying to get a line item in the budget on so we can try to find measurable outcomes for the enforcement program. It's something I know we

want to look into, but I commit to you today that this is something we'll try to improve on.

Senator ALLARD. I've pulled into the second page. It's commodity futures trading—it's "Enforcement of commodity futures and options markets," and that's where the "results not demonstrated" is. That's the way it comes up on the report.

Mr. LUKKEN. Well, we'll make this a priority.

Senator ALLARD. You know, I think it's important. You know, if you can't demonstrate results and effectiveness, maybe you ought to be combined with the SEC, where they know how to do that. I served on the Agriculture Committee and I know you don't want to hear that suggestion. But I've tried to say something that catches your attention.

Mr. LUKKEN. I understand.

Senator ALLARD. I think things need to change there and it's something that I watch very closely. Whenever you show up—you've never had an opportunity to show up before me, but whenever you show up before me you can always expect me to have looked at your PART score to see what you're doing, because it's something I think that's quite helpful as policymakers for us to review.

I served on the Agriculture Committee. I've been pretty impressed actually with your programs, and I understand why you have speculators there and how important they are. I understand that most of your dealings that you have on commodities futures and trading are, they're hedging. They're buying and selling in a timely way so that they reduce their risk. And I think you serve a good and valuable function in that way and you help our markets a lot.

You want to increase your fees. Have you looked at how a fee increase might impact your global marketing?

Mr. LUKKEN. A fee increase has been suggested by OMB to try to help us with raising money. This is not something, a position that the Commission has taken, whether it's in support or not in support of a fee. I think we believe, and different Commissioners can talk about this, their own personal view, that this is something that Congress and OMB should have a discussion about, how to raise the money.

From my point of view, I'm here to describe how we spend the money, the types of programs we need to ensure illegal activity is not occurring on the marketplace.

Senator ALLARD. You're the only regulatory agency that doesn't collect a fee.

Mr. LUKKEN. That's my understanding, we're the only agency that does not have a fee.

Senator ALLARD. And I think your input is important. I wouldn't just leave it up to the OMB and Congress, because we don't understand the world markets. You're out there dealing in the world markets. You're dealing with other exchanges throughout the world and you understand, I think, the impact, how the impact would be on your customers and whether you continue to do business in a competitive way. So I hope you don't back away on that.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Allard, I'm going to pass down this performance and accountability report. I had not seen it before, but the staff shared it with me. And we'll let you take a look at it. It may address some of your earlier questions, and see if it does.

Senator ALLARD. We just pulled this off the Internet before I came here to the subcommittee meeting. So maybe it's not updated there.

Senator DURBIN. Okay. Thank you.

Senator ALLARD. It's probably the same as what we've got in here.

IMPACT OF BIOFUELS MANDATE ON PRICE INCREASES

Senator DURBIN. Chairman Lukken, last month you had a roundtable at CFTC to talk about changes in the marketplace. I'm glad you did it. In your opening remarks you said: "During the last year the price of rice has increased 118 percent, wheat 95 percent, soybeans 88 percent, corn 66 percent, cotton and oats by 47 percent. These price levels, combined with record energy costs, have put a strain on consumers as well as many producers and commercial participants that utilize the futures market to manage risk and discover prices."

Now, the big question we're facing is the impact of the biofuels mandate on this phenomenon. I wonder if you could tell me whether or not you considered that element and have an opinion as to whether this biofuels mandate can be linked to any of these price increases?

Mr. LUKKEN. I think the economists that follow those markets very closely, our agricultural markets, believe ethanol is a factor that is affecting the price of not only corn, but other commodities around that may substitute acreage from corn. So this is something that we closely—I can't comment on the mandate itself, but certainly when nearly one-third of corn production is going now for biofuels, that's going to have an impact on corn, on wheat, on soybeans and others that may be involved or be interrelated to the price of corn.

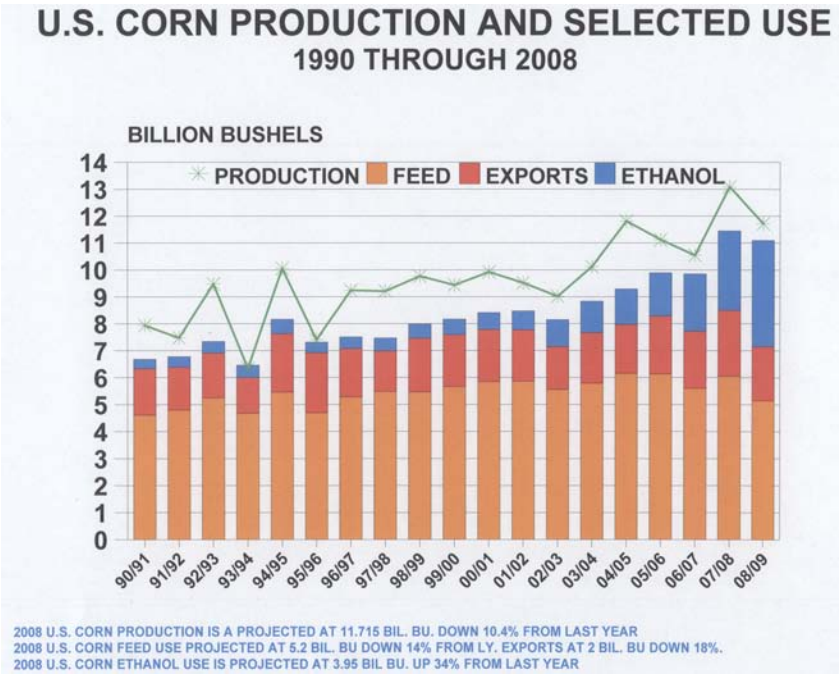
Senator DURBIN. Have you considered—I'm told that there's still more American corn exported than converted to ethanol. Have you considered why that element is still there if in fact we have a short domestic market in corn?

Mr. LUKKEN. I'm not sure if that's something we've studied intensively or not. But it's something we can get back to you on later.

Senator DURBIN. Would you, please.

Mr. LUKKEN. Yes.

[The information follows:]



CFTC–SEC COORDINATION

Senator DURBIN. The last question I have relates to the next panel and that is the memorandum of understanding (MOU) that I understand that you and SEC Chairman Cox have worked on. Could you comment on that and how you are trying to coordinate the activities of your two agencies?

Mr. LUKKEN. I think both Chairman Cox and I recognize how our agencies have to collaborate more as our markets become more intertwined. So this was the fruits of that labor, to sign an MOU that allows for information-sharing and for us to discuss the possibility of allowing novel derivative products to get to market quickly.

So we've taken it out for a test ride. There's a couple of Chicago exchanges, in fact, that have submitted products to us that we are—that are out for comment, on ETF gold products. We hope that those are finalized in the coming months. But we also hope to tackle other big issues, such as portfolio margining. To allow more efficient use of margin between the two marketplaces I think would be enormously helpful, and allowing more product choices to consumers.

Senator DURBIN. Have you run into any conflicts with the SEC trying to figure out where a new product coming to market should be regulated?

Mr. LUKKEN. Well, certainly we have differing missions. Theirs is capital formation. They have insider trading provisions that they have to think about. Ours are risk management markets. So we come at this from different angles. Certainly we have to discuss our

mandates and make sure that we can align those mandates properly.

Certainly we have differences of opinion, but we try to work through them, and understanding that collaboration is the way forward for both of our agencies.

Senator DURBIN. Thank you.

Senator Brownback.

Senator BROWNBACK. Thank you.

LONG CONTRACTS HELD BY INDEX FUNDS

What percentage of open long contracts are held by index funds? Do you have that number?

Mr. LUKKEN. I think it's about 30 percent across, 30 percent across the agricultural sector.

Senator BROWNBACK. Do you know about it in other sectors as well?

Mr. LUKKEN. Again, we only break this out for agricultural products at the moment. We're looking into whether we can do that, given resources, for energy complex.

Senator BROWNBACK. I really want to urge you to do that in the energy complex. But it's 30 percent of the positions across agriculture. Does that vary substantially based on what it is in—corn or wheat or beef?

Mr. LUKKEN. We do have a graph that we can give to your staff, but it ranges anywhere from about 45 percent in live cattle, which again I mentioned actually was in negative territory this year, down to around 15 percent in other commodities.

But they typically are somewhere in the range of 25 to 30 percent in the agricultural commodities.

Senator BROWNBACK. And what were they several years ago, if you'd know? Do you know any of those historic numbers?

Mr. LUKKEN. I think when we started tracking this they were about 27 percent, 27 to 28 percent. So they've grown slightly over the last couple years, but not significantly. We haven't seen a huge uptick in growth since we started tracking this in the agricultural area.

ETHANOL IMPACT ON GAS PRICES

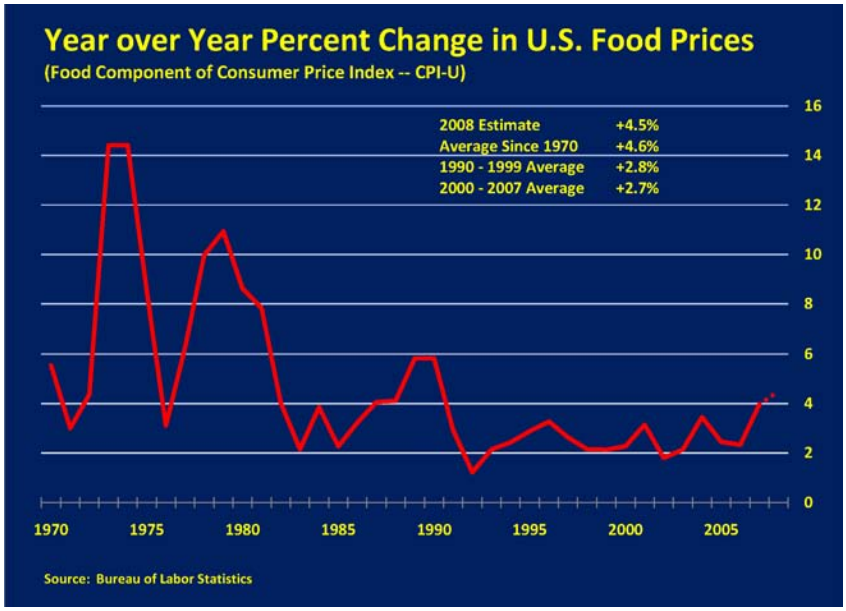
Senator BROWNBACK. You've noted that you think the price of corn is being impacted by ethanol, and certainly the ethanol consumption of corn would have an impact on corn prices. I don't know if you've tracked the impact of ethanol on gasoline prices. Do you track that at all?

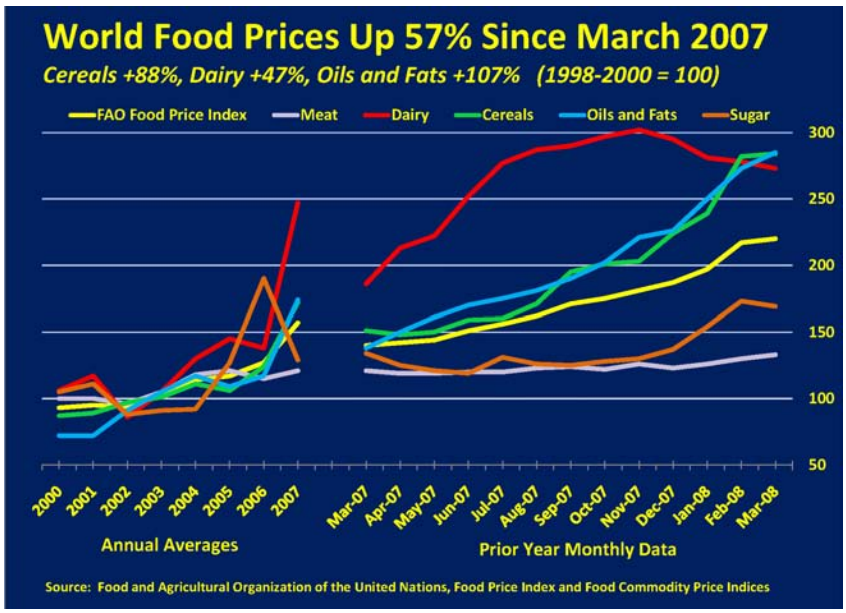
Mr. LUKKEN. I'm not sure this is something—no, I don't think so.

Senator BROWNBACK. Just for the record, I would put this out, and I've got a couple of charts and articles, Mr. Chairman, I would like to put in the record.

Senator DURBIN. Without objection.

[The information follows:]


Year over Year Percent Change in U.S. Food Prices
(Food Component of Consumer Price Index -- CPI-U)
2008 Estimate +4.5%
Average Since 1970 +4.6%
1990 - 1999 Average +2.8%
2000 - 2007 Average +2.7%
16
14
12
10
8
6
4
2
0
1970
1975
1980
1985
1990
1995
2000
2005
Source: Bureau of Labor Statistics


World Food Prices Up 57% Since March 2007
Cereals +88%, Dairy +47%, Oils and Fats +107% (1998-2000 = 100)
FAO Food Price Index
Meat
Dairy
Cereals
Oils and Fats
Sugar
300
250
200
150
100
50
2000
2001
2002
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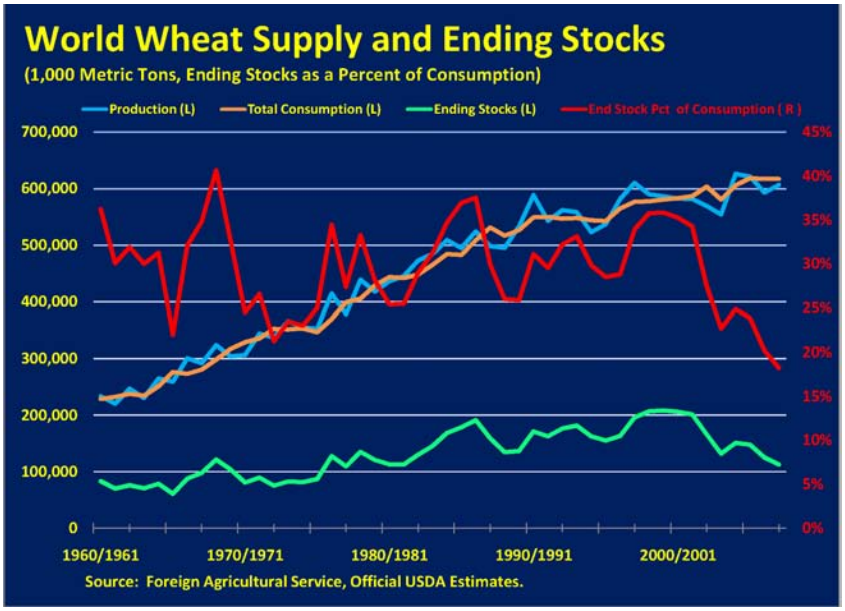
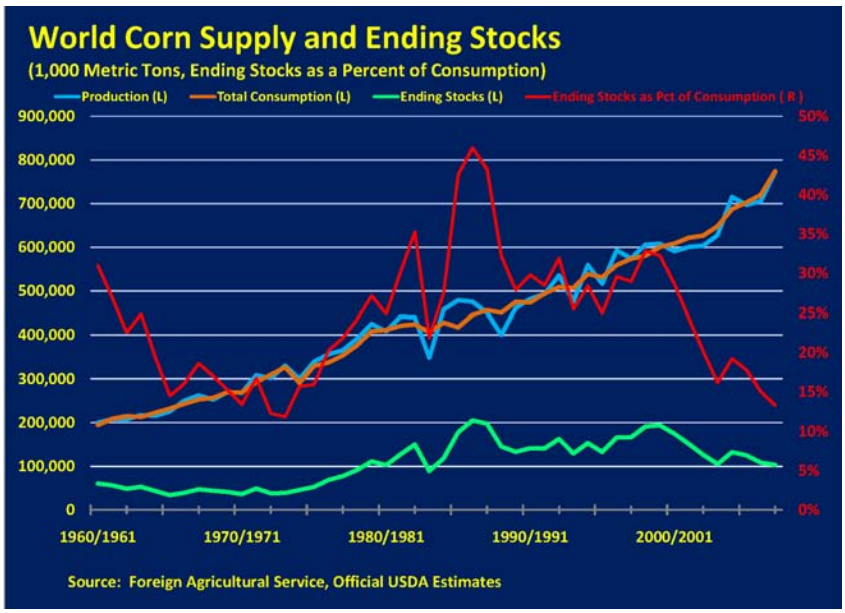
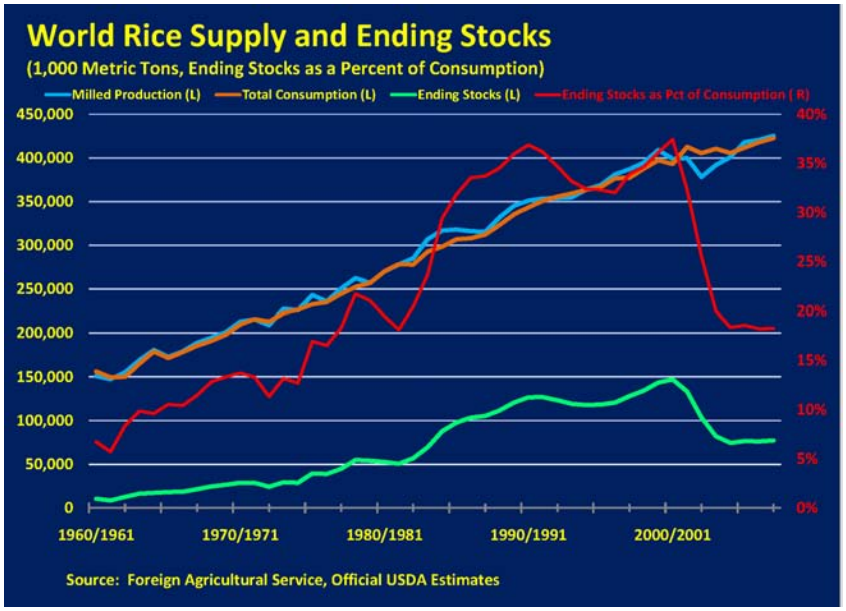
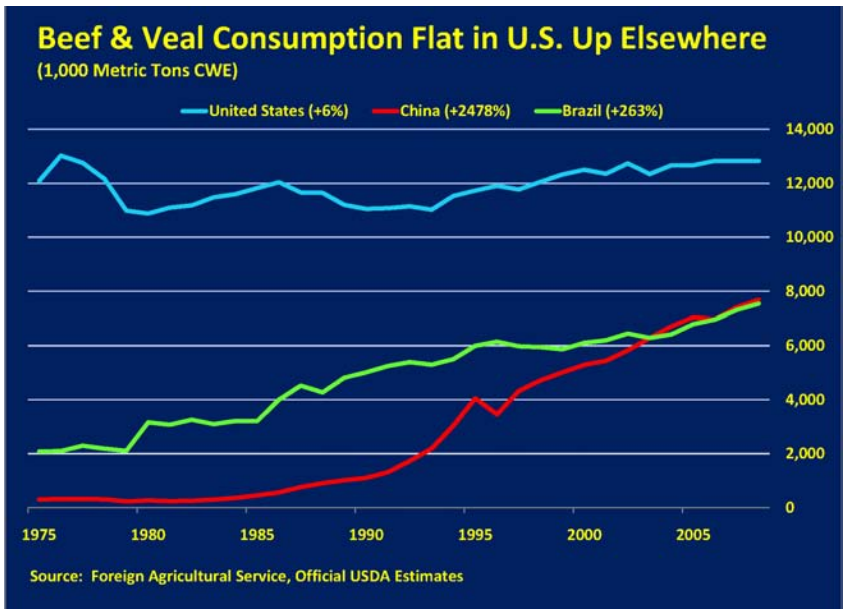
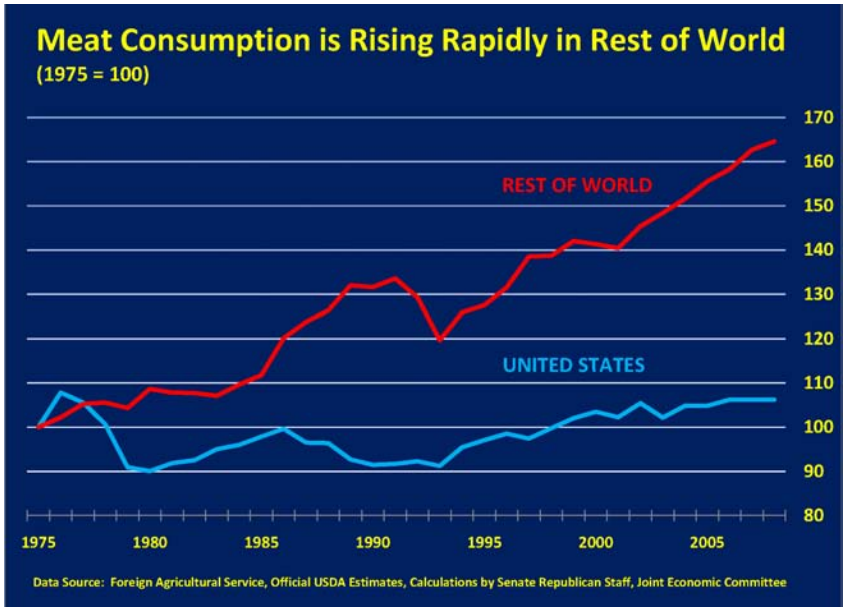
Mar-07
Apr-07
May-07
Jun-07
Jul-07
Aug-07
Sep-07
Oct-07
Nov-07
Dec-07
Jan-08
Feb-08
Mar-08
Annual Averages
Prior Year Monthly Data
Source: Food and Agricultural Organization of the United Nations, Food Price Index and Food Commodity Price Indices


World Wheat Supply and Ending Stocks
(1,000 Metric Tons, Ending Stocks as a Percent of Consumption)
Production (L)
Total Consumption (L)
Ending Stocks (L)
End Stock Pct of Consumption (R)
700,000
600,000
500,000
400,000
300,000
200,000
100,000
0
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1960/1961
1970/1971
1980/1981
1990/1991
2000/2001
Source: Foreign Agricultural Service, Official USDA Estimates.


World Corn Supply and Ending Stocks
(1,000 Metric Tons, Ending Stocks as a Percent of Consumption)
Production (L)
Total Consumption (L)
Ending Stocks (L)
Ending Stocks as Pct of Consumption (R)
900,000
800,000
700,000
600,000
500,000
400,000
300,000
200,000
100,000
0
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1960/1961
1970/1971
1980/1981
1990/1991
2000/2001
Source: Foreign Agricultural Service, Official USDA Estimates


World Rice Supply and Ending Stocks
(1,000 Metric Tons, Ending Stocks as a Percent of Consumption)
Milled Production (L)
Total Consumption (L)
Ending Stocks (L)
Ending Stocks as Pct of Consumption (R)
450,000
400,000
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
40%
35%
30%
25%
20%
15%
10%
5%
0%
1960/1961
1970/1971
1980/1981
1990/1991
2000/2001
Source: Foreign Agricultural Service, Official USDA Estimates


Beef & Veal Consumption Flat in U.S. Up Elsewhere
(1,000 Metric Tons CWE)
United States (+6%)
China (+2478%)
Brazil (+263%)
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
1975
1980
1985
1990
1995
2000
2005
Source: Foreign Agricultural Service, Official USDA Estimates



[From The Wall Street Journal, Mar. 24, 2008]

AS BIOFUELS CATCH ON, NEXT TASK IS TO DEAL WITH ENVIRONMENTAL, ECONOMIC IMPACT

(By Patrick Barta)

The world's economy is acquiring a new energy addiction: biofuels.

Crop-based fuels such as ethanol and biodiesel are quietly becoming a crucial component of the global energy supply, despite growing concerns about their impact on the environment and world food prices.

Biofuels production is rising rapidly, while other fuel sources are failing to keep pace with demand. As a result, biofuels are making up a larger portion of the world's energy-supply gap than many analysts expected. That means the debate over biofuels probably will shift from whether they are good or bad to the more difficult question of how to make sure their production keeps growing—without wreaking economic and environmental havoc.

Global production of biofuels is rising annually by the equivalent of about 300,000 barrels of oil a day. That goes a long way toward meeting the growing demand for oil, which last year rose by about 900,000 barrels a day.

Without biofuels, which can be refined to produce fuels much like the ones made from petroleum, oil prices would be even higher. Merrill Lynch commodity strategist Francisco Blanch says that oil and gasoline prices would be about 15 percent higher if biofuel producers weren't increasing their output. That would put oil at more than $115 a barrel, instead of the current price of around $102. U.S. gasoline prices would have surged to more than $3.70 a gallon, compared with an average of a little more than $3.25 today.

Biofuels are playing "a critical role" in satisfying world demand, says Fatih Birol, chief economist of the Paris-based International Energy Agency. Without them, "it would be much more difficult to balance global oil markets," he said.

The implications are huge. After an initial burst of enthusiasm in 2005 and 2006, environmentalists and some economists now blame biofuels for a host of global problems. These include a sharp jump in the price of corn and other biofuel crops, which has triggered a rise in global inflation and protests in poor nations.

Many environmentalists now believe biofuels contribute substantially to greenhouse gases—those responsible for global warming—instead of reducing them, as was previously believed, in part because farmers clear forest land to grow biofuel

crops. Scientists say deforestation causes a large, quick release of carbon into the atmosphere when existing plant life is destroyed.

International agencies, including the Food and Agriculture Organization of the United Nations, have called on governments to deal with problems caused by biofuels, and some countries have started to rethink their support for the fuels. But cutting back on them won't be easy. Just as developing nations continue to gobble up coal, despite the high environmental cost, Western consumers seem to want whatever it takes to ensure enough fuel for their cars.

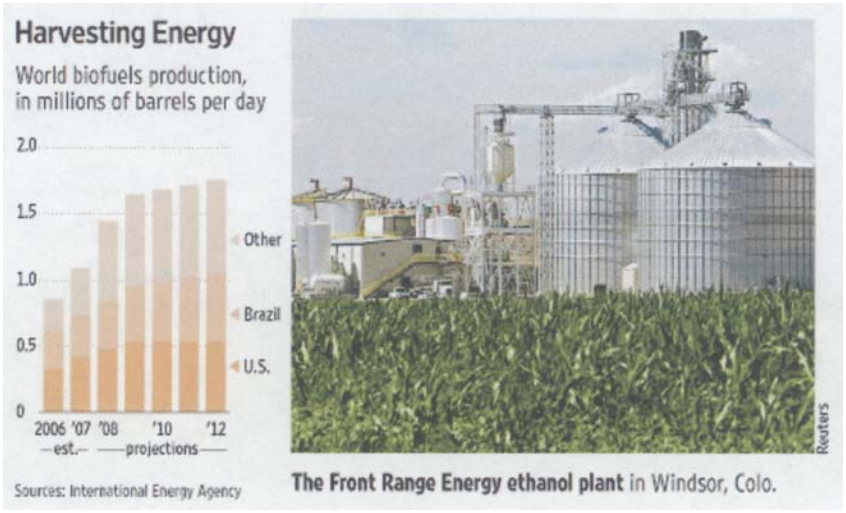
As global energy consumption grows, "there will be pressure to continue relying on these sources regardless" of their negative impacts, says Jeff Brown, a Singapore-based economist at consulting firm FACTS Global Energy Group. "The only other choice is higher [oil] prices."

It's possible newer biofuels will be developed that pose fewer problems. In India and Africa, farmers are expanding production of jatropha, an inedible shrub that is grown on marginal land and requires relatively little water. There also is rising interest in miscanthus, a perennial grass grown in Britain and elsewhere that can be used to generate energy without driving up the cost of crops needed for human consumption.

Still, most farmers prefer to grow biofuel crops they are familiar with, such as corn. And most "second-generation" biofuels are coming on more slowly than many experts had hoped, meaning it might be several years, if ever, before they are viable on a large scale.

It is also possible that "first-generation" biofuels like palm oil-derived biodiesel will run into constraints that would make it difficult to boost their production. The cost of raw materials like palm oil has shot up over the past year, cutting into profits for biofuel producers and forcing some to idle refineries or cancel new ones. It is also unclear whether there is enough land or water left to keep boosting biofuels' production at their current rate of increase.

But a slowdown in biofuel production would only tighten world energy markets—and further highlight the world's dependence on the fuels, especially as producers of traditional crude oil struggle to crank up their supply.



Earlier this month, Exxon Mobil Corp. said it planned to boost capital spending by several billion dollars in 2008 to roughly $25 billion, and yet production levels will likely stay about the same this year. Mr. Blanch at Merrill Lynch says he expects new oil from producers outside the Organization of Petroleum Exporting Countries to taper off to as little as 300,000 barrels a day by 2011—about the equivalent of today's annual increase in biofuels production.

Production from OPEC is tougher to forecast, in part because of the unpredictable political forces that shape the group's decisions. Last year, however, the cartel's output, including that of new members Angola and Ecuador, declined by about 400,000 barrels a day, according to the IEA. OPEC has lately decided to hold production at its current levels despite oil prices in excess of $100 a barrel.

All of that can only mean one thing: With so many challenges ahead for increasing oil supplies, the world will have to get used to relying on biofuels—or find yet another alternative, at a time when there aren't many.

THE RELATIVE IMPACT OF CORN AND ENERGY PRICES IN THE GROCERY AISLE

(John M. Urbanchuk, Director, LECG LLC, June 14, 2007)

Retail food prices measured by the Consumer Price Index (CPI) for food have begun to accelerate and are beginning to approach rates of increase last seen in mid-2004. Critics of renewable fuels are blaming the recent increases on high prices for corn caused by increasing ethanol production. They fail to point out that corn prices are only one of many factors that determine the CPI for food, and in fact, directly affect a small share of retail food prices. Increases in energy prices for example exert a greater impact on food prices than does the price of corn. A 33 percent increase in crude oil prices—which translates into a $1.00 per gallon increase in the price of conventional regular gasoline—results in a 0.6 percent to 0.9 percent increase in the CPI for food while an equivalent increase in corn prices ($1.00 per bushel) would cause the CPI for food to increase only 0.3 percent.

The purpose of this study is to examine and compare the impact on consumer food prices resulting from increases in petroleum and corn prices.

Background

The ethanol and corn industries are under attack by a wide range of critics for causing everything from sharply higher food prices for American consumers to shortages of and high prices for Mexican tortillas and even potentially higher tequila prices. Expansion of the ethanol industry to meet clean air standards and reduce dependence on imported petroleum has boosted demand for corn, the primary feedstock for U.S. ethanol. This increased demand has caused corn prices to rise to their highest levels since the drought of 1995. Critics contend that the recent increase in retail food prices measured by the CPI for food is the direct result of higher corn prices caused by ethanol demand and that an even larger increase in food prices is in store for American consumers.

The actual record on the relationship between ethanol, corn, and retail food prices is less clear. Over the past 5 years, ethanol production has more than doubled, increasing from 2.14 billion gallons in 2002 to 4.86 billion gallons in 2006. Over this same period, the demand for corn to produce ethanol has grown from 996 million bushels to 2.2 billion bushels. Over most of this period, cash market corn prices were relatively stable. From January 2002 through September 2006, corn prices averaged $2.18 per bushel. However, between September 2006 and May 2007, corn prices jumped 61 percent to $3.56 per bushel in May 2007.

During this same period, the CPI for food averaged a year-over-year increase of 2.4 percent. In fact, the inflation rate for food declined from a 5-year peak of 4.1 percent in May 2004 to a 2.5 percent year-over-year rate in September 2006. However, since September 2006 the CPI for food has accelerated to a year-over-year rate of 3.7 percent in April 2007, an increase of 1.2 percent. During this same period, cash market corn prices increased $1.15 per bushel. While it is tempting to blame the entire increase in food price inflation over the past 8 months on higher corn prices, most of the increase in food prices was the result of foods not impacted by corn such as fish, fruits and vegetables, sugar and sweeteners, and food away from home. Meat, poultry, eggs, and dairy products—the foods where corn is a major input and are most affected by rising corn prices—accounted for about 0.2 percent of the 1.2 percent acceleration in food price inflation between September 2006 and April 2007. Rising energy prices had a more significant impact on food prices than did corn.

Year-over-year increases in the CPI for all items, CPI for food and selected components are shown in Table 1.

TABLE 1.—CPI URBAN WORKERS

[Percent change, year-over-year]

	All items	All food	Cereals and bakery products	Meat, poultry, fish	Beef and veal	Pork	Poultry	Eggs	Dairy
2002	1.6	1.8	2.2	0.5	0.1	−0.4	1.3	1.3	0.6
2003	2.3	2.2	2.4	4.0	9.0	1.9	1.3	13.8	−0.1
2004	2.7	3.4	1.6	7.4	11.5	5.6	7.5	6.2	7.3
2005	3.4	2.4	1.5	2.4	2.6	2.0	2.0	−13.7	1.2
2006	3.2	2.4	1.8	0.8	0.8	−0.2	−1.8	4.9	−0.5
January 2007	2.1	2.4	2.7	1.7	0.2	1.4	0.2	11.8	−0.1
February 2007	2.4	3.1	4.1	1.7	1.4	0.5	1.0	29.1	0.2
March 2007	2.8	3.3	3.6	2.8	2.3	2.2	2.1	20.8	1.5
April 2007	2.6	3.7	4.5	3.7	4.7	0.7	4.6	18.6	2.5

Annual average and recent monthly average market prices for corn, soybean meal, Distiller's grains, and regular gasoline are shown in Table 2. The shift in corn prices that occurred in late 2006 is clearly evident and has been mirrored by soybean meal and Distiller's grains. During this same period energy price also accelerated rapidly. For example, the national average price of conventional regular gasoline increased 89 cents per gallon (39 percent) between October 2006 and May 2007.

TABLE 2.—MARKET PRICES FOR FEED AND GASOLINE

Calendar year	Corn No. 2 Yellow central Illinois ($/bushel)	SBM High Pro decatur ($/cwt)	DDG L'burg ($/cwt)	Regular gasoline ($/gallon)
2002	$2.17	$167.36	$81.55	$1.38
2003	2.29	200.00	91.66	1.60
2004	2.39	237.01	105.18	1.89
2005	1.90	188.08	75.71	2.31
2006	2.41	175.85	89.01	2.62
January 2007	3.66	190.56	118.00	2.29
February 2007	3.90	208.81	129.00	2.32
March 2007	3.76	205.26	130.88	2.61
April 2007	3.36	.....	.....	2.89
May 2007	3.56	.....	.....	3.19

Livestock and poultry producers are beginning to respond to higher feed costs by slowing the growth in animal numbers and market prices are reflecting these changes. However, corn prices are only one of several factors that impact livestock and meat production.

—Heavy cow and calf slaughter and early placement of feeder cattle in feedlots have combined with poor fall and winter pasture conditions and higher grain prices to set the stage for slower growth in cattle numbers through early 2008. This will in turn slow growth in beef production in 2008 and support higher beef prices.

—Growth in hog inventories are expected to be constrained by higher feed costs. However, this will be offset by growth in domestic demand supported by a stronger consumer economy and increases in exports as China turns to the U.S. to offset sharply reduced domestic pork production.

—Higher feed costs will dampen broiler producer's zest to sharply expand production. However, producers will respond to higher prices for red meat and growth in real disposable income that will support demand growth. This will moderate any potential sharp increases in broiler prices in 2008.

Recent data for beef, pork, and broiler production and market prices are summarized in Table 3.

TABLE 3.—SELECTED LIVESTOCK, POULTRY PRODUCTION, AND PRICES

	Cattle on feed (thousands of head)	Beef and veal production (millions of pounds)	Steer price Omaha direct ($/cwt)	Pork production (millions of pounds)	Barrows and gilts national base	Hog and pig inventory (thousands of head)	Broiler production (millions of pounds)	Broiler price 12-city average ($/cwt)
2002	9,910	27,090	$67.04	19,664	$34.91	59,722	32,240	$55.52
2003	9,124	26,238	84.69	19,945	39.45	59,554	32,749	62.00
2004	11,253	24,547	84.75	20,511	52.48	60,444	34,063	74.10
2005	11,299	24,682	87.28	20,685	50.01	60,975	35,365	70.80
2006	11,726	26,071	85.41	20,999	47.28	61,449	35,752	64.30
January 2007	11,974	2,178	86.75	1,898	44.04	62,149	3,015	70.43
February 2007	11,726	1,965	88.68	1,636	48.60	.....	2,656	75.89
March 2007	11,599	2,131	96.39	1,861	46.00	.....	2,903	78.66
April 2007	11,644	2,027	98.04	1,711	48.43	.....	2,905	78.63
May 2007	.....	2,279	95.90	1,759	54.00	.....	3,259	80.50

Analysis

Retail food prices are not likely to accelerate significantly in 2008 and beyond, even as ethanol production continues to expand. In fact, consumers will be more severely affected by rising gasoline and energy prices than by increases in corn prices.

Increasing petroleum prices have about twice the impact on consumer food prices as equivalent increases in corn prices. A 33 percent increase in crude oil prices—the equivalent of $1.00 per gallon over current levels of retail gasoline prices—would increase retail food prices measured by the CPI for food by 0.6 to 0.9 percent. An equivalent increase in corn prices—about $1.00 per bushel over current levels—would increase consumer food prices only 0.3 percent.

The reason for the larger impact on food prices from petroleum and energy prices stems from the relative importance of energy in food production, packaging, and distribution compared to that of a single ingredient. While petroleum and energy prices affect virtually all aspects of agricultural raw material transportation, processing, and distribution of all finished consumer food products, corn prices affect only a segment of consumer foods—livestock, poultry, and dairy. Corn is an important feed ingredient for livestock and poultry producers and changes in corn prices can have significant impacts on profitability and production. However, meat, poultry, fish, eggs, and dairy products account for only one-fifth of the CPI for food which, in turn, is only 15 percent of the overall CPI.

Crude oil and refined petroleum prices have increased sharply over the past several years and have put considerable pressure on consumers. Energy plays a significant role in the production of raw agricultural commodities, transportation and processing, and distribution of finished consumer food products. Several studies have looked at the impact of increased energy prices on food prices.

—Reed, Hanson, Elitzak and Schluter utilized three different model structures to examine the impact of a doubling of crude oil prices on the CPI for food.[1] They conclude that the short run impact of a doubling (e.g., 100 percent increase) in crude oil prices would cause a 1.82 percent rise in average food prices in the short run and 0.27 percent in the long run.

—A more recent analysis published by Chinkook Lee examined the impact of energy price increases as an intermediate input for food processing and concluded that a 10 percent increase in energy prices results in a 0.2709 percent increase in the purchase (consumer) price of food and kindred products prices.[2]

As pointed out, earlier corn prices also have increased significantly over the past year as the markets have recognized the impact of increasing ethanol production on corn demand. The price of No. 2 Yellow corn at Central Illinois averaged $3.56 per bushel in May 2007, nearly 60 percent higher than year ago levels. The USDA and many private sector forecasters project ethanol production to exceed 15 billion gallons by 2017, utilizing more than 4 billion bushels of corn and maintaining corn prices well above $3.00 per bushel for most of the decade.

We evaluated the impact of an increase in petroleum prices on consumer prices food prices by applying the impact elasticities summarized above to an assumed 33 percent increase in crude oil (the equivalent of a $1.00 increase in retail gasoline prices from current levels). To determine the impact of an increase in corn prices on livestock, poultry, dairy and consumer food prices we imposed a 33 percent increase in corn prices (about $1.00 per bushel from current levels) on the current LECG agricultural sector baseline forecast over the 5-year period 2007 through 2012. This is consistent with the increase in corn prices that has occurred over the past year.

The analyses by Reed and Lee indicate that a 33 percent increase in oil/energy prices would increase retail food prices by 0.6 percent and 0.9 percent. Reed indicates that a 100 percent increase in crude oil prices results in a short-term increase of 1.82 percent in consumer food prices while Lee reports that a 10 percent increase in energy prices provides a 0.2709 percent increase in retail food prices. Restating these on an equivalent 33 percent basis (1.82 percent times .33 and 0.2709 times 3.3) provides the 0.6 to 0.9 percent range.

As shown in Table 4, the equivalent 33 percent increase in corn prices over the 5-year period is expected to reduce beef, pork, and broiler production by 2.6 percent between 2008 and 2012 and increase prices by 2.4 percent. Combined with higher turkey, egg, and dairy prices, the CPI for food is projected to increase an additional 0.3 percent. This result is consistent with the 0.2 percent contribution to food price

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[1] A.J. Reed, Kenneth Hanson, Howard Elitzak, and Gerald Schluter. "Changing Consumer Food Prices: A User's Guide to ERS Analyses". USDA Economic Research Service. Technical Bulletin 1862. June 1997.

[2] Lee, Chinkook. "The Impact of Intermediate Input Price Changes on Food Prices: An Analysis of "From-the-Ground-Up" Effects." *Journal of Agribusiness* 20, 1 (Spring 2002).

inflation between September 2006 and April 2007 from meat, poultry, fish, and dairy and the $1.15 per bushel increase in cash market corn prices.

TABLE 4.—IMPACT OF A $1.00 CORN PRICE INCREASE ON LIVESTOCK, POULTRY, AND CONSUMER FOOD PRICES

[Average 2008–2012]

	Baseline	Scenario	Percentage change
Corn Price, Average Farm ($/bu)	$3.10	$4.10	33.0
Beef and Veal Production (millions of pounds)	25,778	25,749	−0.1
Pork Production (millions of pounds)	21,057	20,696	−1.7
Broiler Production (millions of pounds)	35,530	33,740	−5.0
Steer Price, Omaha Direct ($/cwt)	$98.41	$98.59	0.2
Barrows and Gilts, Market ($/cwt)	$49.95	$50.99	2.1
Broilers, 12-City Average (cents/lb)	$77.90	$82.09	5.4
CPI, Food (percent)	2.3	2.6	0.3
CPI, Food at Home (percent)	1.9	2.2	0.3
CPI, Meats, Poultry, Eggs (percent)	1.4	2.1	0.7

Conclusion

The days of cheap corn are more likely than not over. Livestock and poultry producers who enjoyed low and relatively stable corn (and other feed) prices over most of the past decade are now faced with the challenge of adjusting to an environment of higher feed prices. The new reality is that corn prices are likely to remain nearer to the $3.00 per bushel than the $2.00 per bushel mark for an extended period. The good news is that prices may be more stable as corn production expands to meet ethanol requirements and new ethanol feedstocks and technologies emerge. Livestock and poultry producers also will have an incentive to increase use of the ethanol coproduct Distiller's grains in order to control feed costs. This medium protein feed component can be used in place of corn in a substantial portion of the feed ration. As ethanol production expands, so will production of Distiller's grains and thus putting downward pressure on prices.

Corn and energy prices both affect consumer food prices. However, since increases in corn prices are limited to a relatively small portion of the overall CPI for food, an increase in corn prices resulting from higher ethanol demand or a supply disruption such as a major drought is expected to have about half the impact of the same percentage increase in petroleum and energy prices.

APPENDIX TABLE 1.—CPI ALL URBAN WORKERS

[Percent change from previous year]

	All items	All food	Cereals and bakery products	Beef	Pork	Poultry	Eggs	Dairy products	Fruits and vegetables	Fats, oils
January 2004	1.9	3.5	2.1	20.4	5.4	5.5	30.5	3.6	2.3	3.1
February 2004	1.7	3.3	1.3	16.1	3.6	4.1	31.2	2.9	2.9	2.3
March 2004	1.7	3.2	1.3	12.8	5.5	6.1	33.2	2.9	2.9	5.5
April 2004	2.3	3.4	1.8	13.2	4.8	5.9	26.4	4.9	3.2	6.5
May 2004	3.1	4.1	1.5	15.9	6.6	9.5	19.0	12.4	2.4	7.5
June 2004	3.3	3.7	1.5	16.0	6.3	8.9	10.1	15.2	−0.3	9.5
July 2004	3.0	4.0	1.3	15.4	7.0	9.5	6.3	14.0	−0.9	10.0
August 2004	2.7	3.5	1.3	14.2	7.4	10.5	−1.0	10.4	−0.4	7.6
September 2004	2.5	3.3	1.4	12.2	6.2	9.8	−9.6	6.6	0.7	8.1
October 2004	3.2	3.4	1.9	7.4	5.3	8.3	−12.4	6.0	6.1	6.6
November 2004	3.5	3.2	2.1	0.6	5.2	6.3	−21.1	5.7	9.1	6.7
December 2004	3.3	2.7	1.7	−0.9	4.7	5.1	−19.9	4.1	7.9	6.2
January 2005	3.0	2.9	1.8	1.5	5.5	5.3	−23.0	6.3	4.5	6.0
February 2005	3.0	2.6	2.0	3.5	6.3	4.5	−21.5	5.6	2.2	4.3
March 2005	3.1	2.5	1.8	6.0	4.5	4.0	−27.0	5.5	1.6	0.5
April 2005	3.5	3.1	1.8	5.3	7.0	3.4	−25.9	4.7	5.2	1.9
May 2005	2.8	2.4	1.7	5.0	2.8	1.2	−18.6	−1.4	5.6	−0.9
June 2005	2.5	2.2	1.3	3.3	1.8	1.3	−17.3	−4.1	5.2	−4.0
July 2005	3.2	2.1	1.1	0.8	0.1	0.5	−11.9	−3.2	7.0	−2.7
August 2005	3.6	2.2	1.4	0.8	−0.7	0.1	−12.2	−1.1	5.6	−1.2
September 2005	4.7	2.5	0.9	0.5	−1.0	1.3	1.4	0.1	6.5	−0.6
October 2005	4.3	2.2	1.2	1.4	−0.8	−0.2	−0.6	0.3	2.4	−0.9
November 2005	3.5	2.2	1.1	1.2	−0.2	2.3	5.3	1.4	−0.8	−1.0
December 2005	3.4	2.3	1.0	2.2	−0.1	0.3	1.4	1.7	0.6	−1.3
January 2006	4.0	2.6	1.4	2.8	−1.7	−1.3	8.3	0.2	6.4	−0.3
February 2006	3.6	2.8	0.9	1.3	−1.7	−0.3	−3.1	0.9	7.9	0.6
March 2006	3.4	2.6	1.2	1.2	−1.0	−1.6	5.5	0.9	6.3	0.9
April 2006	3.5	1.8	0.9	0.7	−1.9	−2.0	8.7	−0.5	2.7	−2.6
May 2006	4.2	1.9	1.0	−1.7	−0.8	−2.0	2.4	−1.3	1.3	0.5
June 2006	4.3	2.2	1.6	−1.9	−1.0	−1.4	8.9	−0.8	4.0	1.7
July 2006	4.1	2.2	2.5	−0.5	0.2	−2.7	0.5	−0.4	3.7	−0.2

APPENDIX TABLE 1.—CPI ALL URBAN WORKERS—Continued

[Percent change from previous year]

	All items	All food	Cereals and bakery products	Beef	Pork	Poultry	Eggs	Dairy products	Fruits and vegetables	Fats, oils
August 2006	3.8	2.4	2.1	1.4	1.1	−1.7	6.0	−1.6	5.3	−0.1
September 2006	2.1	2.5	2.5	1.6	1.3	−2.6	−0.8	−1.0	7.2	−0.9
October 2006	1.3	2.6	2.5	2.0	1.6	−1.9	1.5	−0.3	6.5	0.3
November 2006	2.0	2.3	2.6	2.4	0.1	−3.1	6.6	−1.6	4.2	1.1
December 2006	2.5	2.1	3.1	0.5	0.7	−0.7	14.1	−1.2	1.9	0.9
January 2007	2.1	2.4	2.7	0.2	1.4	0.2	11.8	−0.1	1.7	0.2
February 2007	2.4	3.1	4.1	1.4	0.5	1.0	29.1	0.2	6.0	0.8
March 2007	2.8	3.3	3.6	2.3	2.2	2.1	20.8	1.5	6.2	1.4
April 2007	2.6	3.7	4.5	4.7	0.7	4.6	18.6	2.5	6.2	2.9

THE IMPACT OF ETHANOL PRODUCTION ON U.S. AND REGIONAL GASOLINE PRICES AND ON THE PROFITABILITY OF THE U.S. OIL REFINERY INDUSTRY

ABSTRACT

Using pooled regional time-series data and panel data estimation, we quantify the impact of monthly ethanol production on monthly retail regular gasoline prices. This analysis suggests that the growth in ethanol production has caused retail gasoline prices to be $0.29 to $0.40 per gallon lower than would otherwise have been the case. The analysis shows that the negative impact of ethanol on gasoline prices varies considerably across regions. The Midwest region has the biggest impact, at $0.39/gallon, while the Rocky Mountain region had the smallest impact, at $0.17/gallon. The results also indicate that ethanol production has significantly reduced the profit margin of the oil refinery industry. The results are robust with respect to alternative model specifications.

Keywords: crack spread, crude oil prices, ethanol, gasoline prices.

Introduction

Fuel ethanol production in the United States increased from 1.63 billion gallons in 2000 to 7.22 billion gallons in 2007 (RFA). In comparison, the United States consumed approximately 146 billion gallons of petroleum in 2007 (EIA). The purpose of this paper is to estimate the impact of this increase in ethanol supply on the U.S. gasoline market.

Ethanol is blended with gasoline to improve octane and performance in about 50 percent of the Nation's gasoline supply. Typically, a gallon of ethanol blend will have 10 percent ethanol and 90 percent gasoline. This gallon of ethanol blend will contain approximately 97 percent of the energy of a gallon of gasoline (Tokgoz et al. 2007) and will use approximately one-tenth as much fuel energy to produce as it contains (Wang et al. 2007). Therefore, ethanol has essentially added to U.S. gasoline supplies by utilizing solar energy to grow the crop, coupled with energy from natural gas and coal to manufacture the farm equipment and fertilizer used in crop production.

In order to identify the separate impact of ethanol on gasoline prices, we need to separate the impact of ethanol from the other forces driving gasoline prices. We do so by examining the price of gasoline relative to the price of crude oil. We also estimate the impact of ethanol on the profits made by refiners. Both estimates are calculated for the United States as a whole and for each of five regions within the United States. The motivation for conducting the regional analysis is that if ethanol is affecting gasoline prices, then we hypothesize that this impact will be largest in the Midwest where regional ethanol production and utilization is at its maximum.

The paper proceeds as follows. First, background information regarding previous work, relative gasoline prices, and the use of the crack spread as a measure of industry profitability are introduced. We then describe the five regional "Petroleum Administration for Defense Districts" (PADDs) that are the basis for the analysis. Next, we present a detailed description of and motivation for the explanatory variables. We also provide a description of and motivation for the three estimation methods that are used. The last section summarizes the results.

Previous Work

Quantitative analysis of the effect of ethanol on gasoline prices and on the profitability of the refinery industry has been largely neglected in the literature. Eidman (2005) points out that ethanol largely acts as a fuel extender. He also shows that there has been a strong positive correlation between ethanol and gasoline prices. Employing an international ethanol model consisting of behavioral equations for production, consumption, and trade, Tokgoz and Elobeid (2007) analyze the price linkage between ethanol and gasoline markets. They conclude that ethanol is mainly used as an additive to gasoline and that the complementary effect of ethanol dominates the substitution effect on gasoline prices. Szklo, Schaeffer, and Delgado (2007) conclude that by replacing methyl tertiary butyl ether (MTBE), which is a traditional additive used as an oxygenate to raise the octane number, ethanol blending will not reduce gasoline use until flexible fuel vehicles become widely available. Vedenov et al. (2006) apply a continuous-time option pricing method to calculate the decision threshold of switching to ethanol. Their empirical analysis suggests that blending ethanol into gasoline would generate lower gasoline price volatility and that switching from conventional gasoline to an ethanol blend is an economically sound decision.

The "3:2:1 crack spread" is used as one of the significant indicators of refinery profitability. It is a term used in the oil industry and futures trading as a proxy for the profitability of refineries. Although there is some qualitative description of

its determinants, formal quantitative analysis is limited in the literature. Asche, Gjolberg, and Völker (2003) examine the price relationships among crude oil and refined products. They find that the crude oil price is weakly exogenous and that the spread is constant among some of the prices. Girma and Paulson (1998) examine the crack spread of daily futures prices of crude oil and heating oil. Girma and Paulson (1999) investigate the long-run relationship among crude oil, gasoline, and heating oil futures prices and find the prices are co-integrated. They also find a stationary relation between crude oil and its end products.

In the literature on mergers in the refinery industry, several studies rely on analysis of the price margin, which is defined as wholesale prices of gasoline less crude oil prices. The Government Accounting Office (GAO 2004) models the price margin as a function of the crude oil price, inventory ratio, utilization rate, and dummy variables representing a merger and acquisition event. Geweke (2003) provides a comprehensive survey on this subject.

The degree of market concentration has been long recognized and analyzed in the literature seeking to explain price changes and adjustment in the wholesale gasoline market. Focusing on Gulf Coast, Los Angeles, and New York whole spot gasoline markets, Oladunjoye (2007) investigates the effects of market structure on the pattern of price adjustment and finds that market concentration has a significant asymmetric effect on gasoline price changes responding to crude price shocks. The GAO (2004) concludes that mergers and increased market concentration generally led to higher wholesale gasoline prices in the United States from the mid-1990s through 2000. Examining wholesale price responses in 188 gasoline markets in the United States, Borenstein and Shepard (2002) find that refinery firms with market power generally choose a different adjustment rate and adjust prices more slowly than do competitive firms.

Background

The 3:2:1 crack spread is defined as

$$\pi = \frac{2}{3}P_G + \frac{1}{3}P_H - P_O$$

where P_G, P_H, and P_O are the prices of regular gasoline, no. 2 heating oil, and crude oil, respectively.

The 3:2:1 crack spread has been institutionalized over the years as a way to measure the refinery margin. The use of the 3:2:1 crack spread is justified by the fact that among all finished products converted from crude oil in the refinery process, gasoline and distillate fuel oil are the two primary product classes. The relative proportion of these two products is approximately two barrels of gasoline to one barrel of distillate fuel. Together, gasoline and distillate fuel comprise about 80 percent of the refinery yield. The average refinery yield of finished motor gasoline is about 46 percent and has been stable over the 1993–2007 sample period (DOE).

The West Texas Intermediate (WTI) crude oil price, which is priced at Cushing, Oklahoma, is chosen to represent the crude oil price in this study. The reason is that WTI-Cushing is one of the most widely traded and price-transparent crude oils in the U.S. crude oil market.

We use the Petroleum Administration for Defense Districts (PADDs) to define refinery product markets. This market definition was formed during World War II for the purpose of administering oil allocation. The PADDs are still used by the Department of Transportation (DOT) and Energy Information Administration (EIA) for statistical and reporting purposes. The five regions are East Coast (PADD I), Midwest (PADD II), Gulf Coast (PADD III), Rocky Mountain (PADD IV), and West Coast (PADD V). These five geographically distinct regions are also very different in terms of their economic conditions, oil and petroleum characteristics, oil-related pipeline infrastructure, and local product supply and demand conditions.

Because of its high population density, the East Coast PADD I has the highest demand for refined products in the country, but it has very limited refinery capacity. Its regional demand is largely satisfied by the Gulf Coast and by foreign imports. The Midwest PADD II is distinct in its coexistence of a highly industrialized section and a rural agricultural section. It also leads the Nation in ethanol production, mainly because of its leading role in corn production, the primary feedstock for ethanol production. For example, Iowa had 30 ethanol plants in operation by the end of 2007 and produces nearly 2.1 billion gallons of ethanol annually. Much of the crude oil used in the Midwest is piped in from the Gulf Coast and Canada. One place worth mentioning in this region is Cushing, Oklahoma, which is the major crude oil transportation hub for the Midwest.

The Gulf Coast region, including Texas, Louisiana, New Mexico, Arkansas, Alabama, and Mississippi, produces over 50 percent of the Nation's crude oil and 47 percent of its final refined products. This region also serves as a national hub for crude oil and is the center of the pipeline system. The Rocky Mountain region, or PADD IV, has the smallest and fastest-growing oil market in the United States, with only 3 percent of national petroleum product consumption. The West Coast region, PADD V, is the largest oil-producing and consuming region. This region's oil supply is independent of

other regions since it is geographically separated by the Rocky Mountains. In addition, the refinery market of this region is highly concentrated.

Data

The gasoline price relative to that of crude oil is used as a dependent variable to measure ethanol's possible substitution effect on the gasoline price, while the 3:2:1 crack spread is employed as a dependant variable to quantify the effect of ethanol on the refinery profit margin. Figure 1 presents the relative gasoline to crude oil price over the 1995–2007 period. Figure 2 is for the 3:2:1 crack spread deflated by Producer Price Index (PPI) for crude energy material for five PADD regions over the same sample period. The PPI data are obtained from the U.S. Bureau of Labor Statistics.

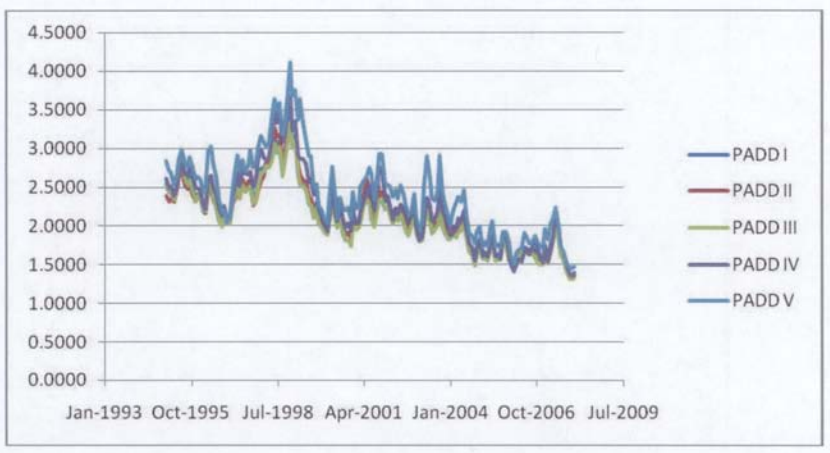

Figure 1. Relative Gasoline Price, 1995-2007

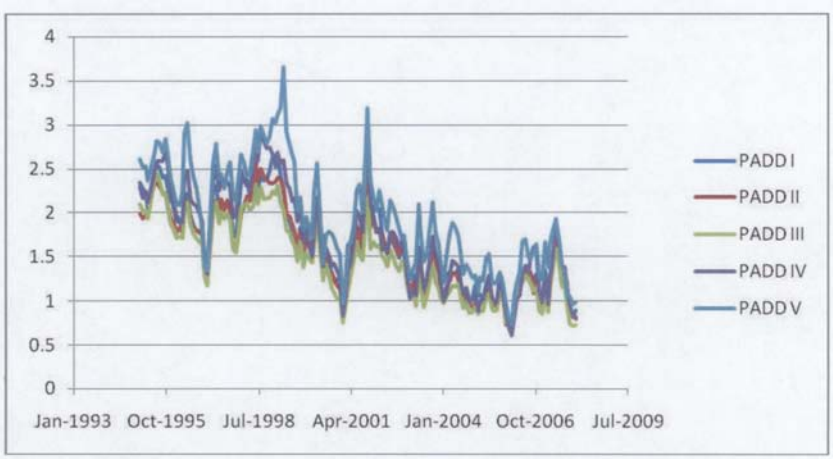

Figure 2. Deflated 3:2:1 Crack Spread, 1995-2007

The relative gasoline price is similar to crack spread in the sense that both are measurements of profitability of the refinery industry. The difference is that relative gasoline prices only account for the contribution of gasoline to the profit margin. It is employed in this study to quantify the substitution effect of ethanol production on gasoline prices. Relative gasoline prices and the refinery profit margin are mainly determined by similar explanatory variables. The explanatory variables included in this study are market demand and supply conditions, refinery capacity and utilization rate, market concentration and structure, unexpected supply disruptions, gasoline imports, seasonality, and ethanol production. Each of these chosen variables and its relationship with the relative gasoline price and refinery profitability is discussed in greater detail in this section.

Crude and Product Market Conditions

The gasoline price and refinery profitability are affected by the supply and demand balances of the crude market and product market. When the crude oil market has ample stocks, refinery profit should increase because of lower crude oil prices. Alternatively, when there are large stocks of gasoline and other refinery products, refinery profits should fall because of lower product prices. A tight product market will generate upward pressure on product prices even when there is an ample supply of crude oil. That is, product prices are bid up by more than any underlying cost increases. This upward movement relative to crude oil prices will be seen as an increase in the relative price and crack spread. We use monthly crude oil inventory and gasoline inventory data collected by the EIA to represent the conditions in these two markets. The gasoline stock and crude oil stock data for the East Coast region from 1995 to 2007 are shown in Figures 3 and 4, respectively.

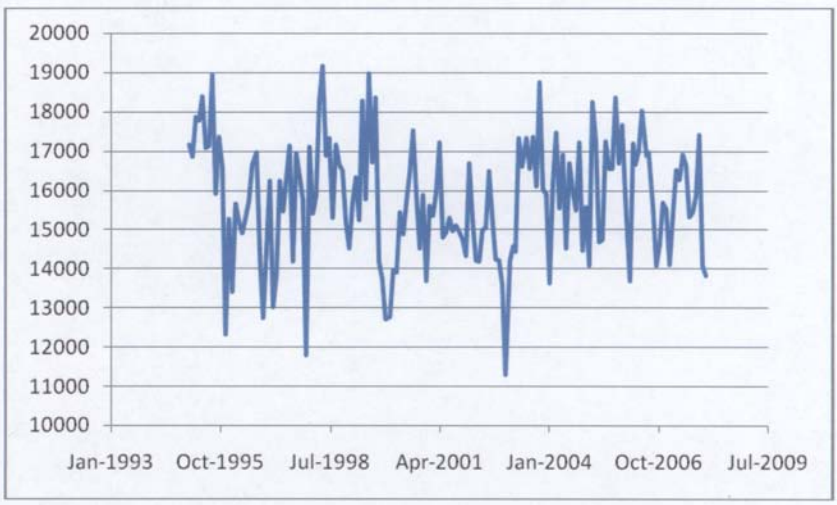

Figure 3. Month-End Oil Stock for PADD 1 (1995-2007)

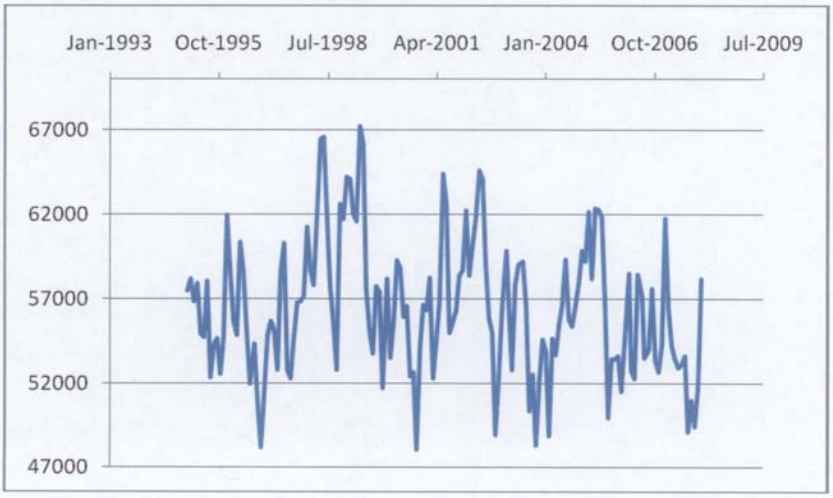

Figure 4. Month-End Gasoline Stock for PADD I (1995-2007)

Refinery Capacity and Capacity Utilization Rate

Refinery capacity is a critical factor influencing the profitability of the refinery industry. Figure 5 presents the operable crude oil distillation capacity in the five PADD regions from 1995 to 2007. In this figure, refinery capacity is represented by monthly data of atmospheric crude oil distillation units (barrels per calendar day). Total refinery capacity increased by 13 percent over the past 12 years, with PADD III, the Gulf Coast, having the highest growth of 19 percent. The lowest increase in capacity occurred in the Midwest, with a 4 percent growth over the same period.

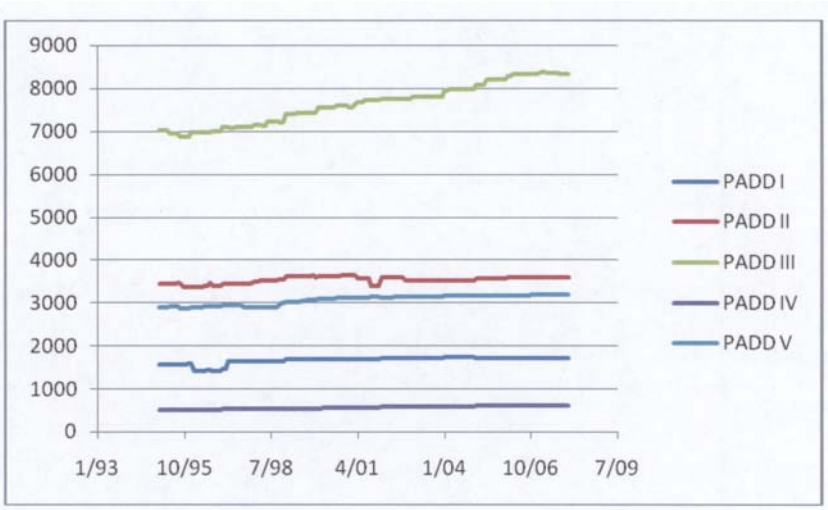

Figure 5. Operable Crude Oil Distillation Capacity (1,000 Barrels/Day)

The monthly percent refinery capacity utilization rates for 1995 to 2007 for PADDs II, III, and V are shown in Figure 6. Here, refinery capacity utilization is based on gross input to atmospheric crude oil distillation units divided by the refinery operable distillation capacity. The average rate over five regions is 92 percent, which means that capacity utilization has increased significantly and refineries are running at high rates of utilization. Refinery capacity and its utilization rate are variables that will affect gasoline price and refinery profits via higher prices for products and possible increases in marginal costs.

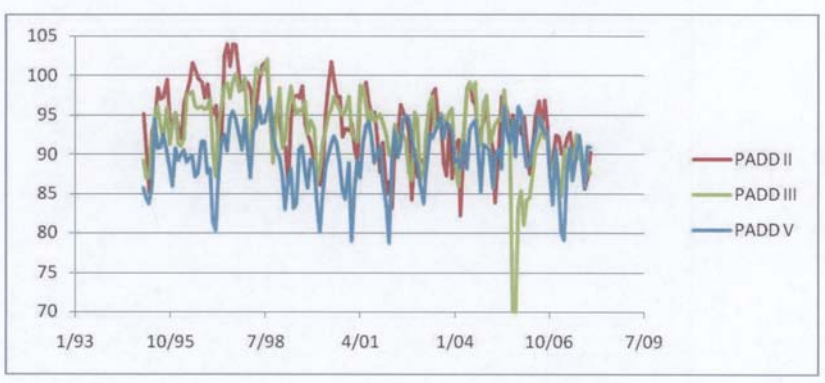

Figure 6. Percent Utilization of Refinery Operable Capacity (PADDs II, III, and V)

Market Concentration

Mergers and acquisitions among refinery firms may potentially further reduce the competition in the refinery market, thus possibly leading to a higher refinery margin. To measure the level of market concentration, the Herfindahl-Hirschman Index (HHI) is commonly applied in the literature. The HHI of a market is calculated by

summing the squares of the percentage market shares held by the respective firms as

$$HHI_t = \sum_{i=1}^{N_t} S_{it}^2$$

where S_{it} is the market share of a specific firm in the corresponding production market with total firms of N_t at year t. A market with an HHI less than 1,000 is considered to be a competitive market; 1,000–1,800 to be a moderately concentrated market, and greater than 1,800 to be a highly concentrated market.

We constructed an HHI for the five PADD regions over the period 1995 to 2007, and we present this information in Figure 7. The HHI for the refinery market in PADD I increased from 1,558 to 2,335 from 1995 to 2007 and changed from a moderately concentrated to a highly concentrated market using Department of Justice definitions. Since much of this region's refinery product supply is from other regions, the impact of this increased concentration may be small. The refinery market in PADD II, the Midwest, suggests that this is a competitive market, although its HHI increased to 960 in 2007. Similar to the Midwest region, PADD III, the Gulf Coast, also has a competitive refinery market as of the end of 2007. The HHI for PADD IV, the Rocky Mountain region, decreased from 1,025 to 930, which suggests that its refinery market became less concentrated than before. The HHI for the PADD V, the West Coast region, increased from 914 to 1,155, and this refinery market changed its definition to a moderately concentrated market by 2007.

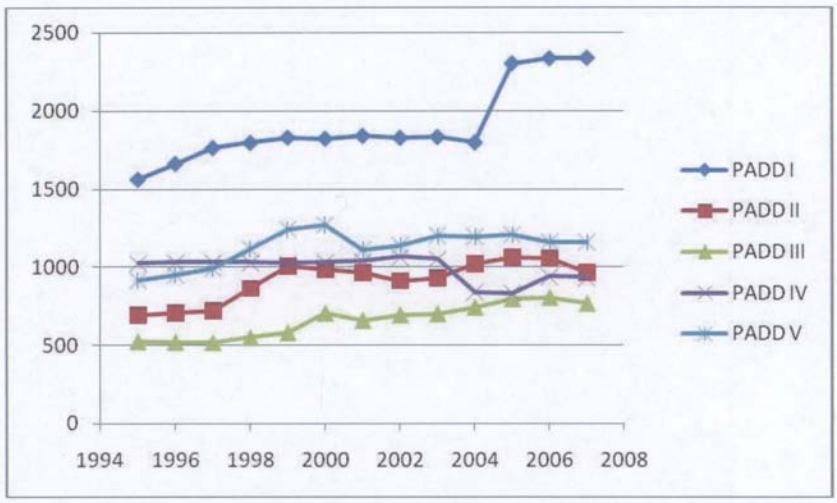

Figure 7. HHI, 1995-2007

Unexpected Supply Disruptions

On August 29, 2005, Hurricane Katrina hit the U.S. Gulf Coast at New Orleans. On September 24, 2005, Hurricane Rita hit at the border between Texas and Louisiana. Both were category four storms when they did significant damage to the refineries' facilities and pipeline in the Gulf Coast region. Refinery operations were reduced by 1.8 million barrel/day in September and October 2005. Retail gasoline prices jumped by $0.50 to over $3.00 per gallon on a national average basis after Hurricane Rita. Prices were distinctly higher than before. In order to control for the effect of this event on the gasoline and refinery profit margin, we include dummy variables for September and October in 2005, when the disruptions were most severe.

Gasoline Imports

A significant share of total gasoline demand in the United States is met by imports. The net import share of total gasoline consumption in 2007 is 14 percent. Figure 8 presents U.S. finished motor gasoline imports from all countries over the period 1995 to 2007. Imports reached their highest level in October 2005, the month after Hurricanes Katrina and Rita. Major sources of gasoline imports include Canada, Europe, and the Virgin Islands. A structural surplus in gasoline production in Europe means that gasoline production costs are lower when derived from foreign sources than they would be if the United States built and operated additional refinery capacity domestically. Growth in imports is expected to be tempered because of the increased use of domestically produced ethanol. Also, with increases in imported gasoline, refinery profitability is expected to be negatively affected.

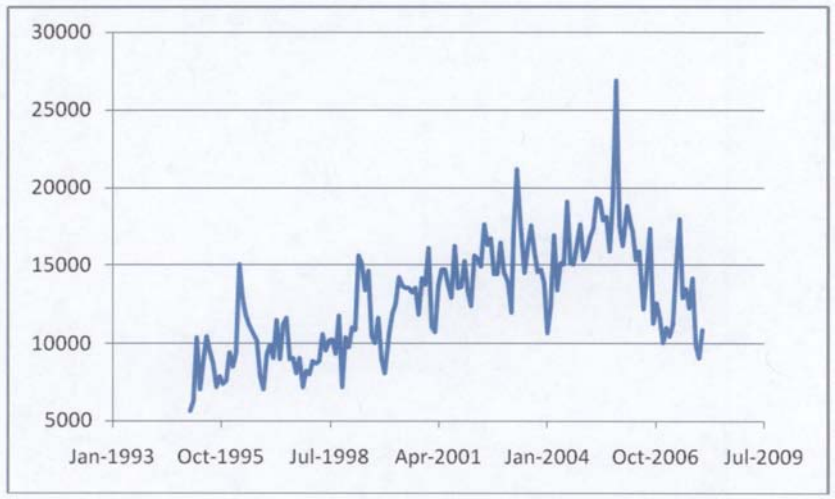

Figure 8. Monthly Motor Gasoline Imports, 1995-2007

Ethanol Production

Figure 9 presents the monthly ethanol production over the 1995–2007 period. There are 68 ethanol plants under construction or expanding. Iowa leads the Nation with about 2 billion gallons of ethanol production capacity. Our hypothesis is that this additional production has had a negative impact on gasoline prices and on the margins of crude oil refiners.

Figure 9. Monthly Ethanol Production, 1995-2007

Seasonality

The gasoline market is highly seasonal due to stronger demand in spring and summer. Gasoline price tends to gradually rise before and after summer. Demand for distillate fuel including heating oil and diesel fuel typically peaks in winter and thus has a counter-cyclical price pattern from gasoline. We include a set of monthly dummies to account for the seasonal pattern.

Estimation Method

The regression model is specified as follows:

$$\pi_{it} = X_{it}^{'}\beta + \varepsilon_{it} \qquad i = 1,...,N; t = 1,...T. \tag{1}$$

where π_{it} it is the price of gasoline divided by the price of crude oil or the 3:2:1 crack spread of region i at month t, and X_{it} is the K-dimensional vector of explanatory variables described earlier.

There are several options for estimating equation (1), including pooled OLS regression and panel data models. The pooled OLS regression simply pools together data series for all PADD regions and applies the ordinary least squares method. The OLS estimates of the standard errors may be highly inaccurate if the data exhibits heteroskedasticity and/or cross-sectional and serial correlation. The panel data models increase precision of estimates and allow us to control for an unobservable individual region's heterogeneity and temporal effects without aggregation bias.

The Hausman test for misspecification (Greene 2003, p. 301) is employed to help us select from two principal types of panel data models: the fixed effect model and the random effect model. Under the null hypothesis, the random effects estimator is consistent and efficient, while under the alternative, it is inconsistent. The random effect model is chosen if we fail to reject the null hypothesis. In the case of relative gasoline price (3:2:1 crack spread), the χ^2 test statistic was calculated at 26.92 (48.99) and significant at the 5 percent (1 percent) significance level. This suggests that the fixed effect estimator is consistent and asymptotically efficient in both cases.

Different specification tests are applied on the data set to better specify the panel data model. Applying the Wooldridge test for autocorrelation in panel data for the relative gasoline price (or crack spread) (Wooldridge 2002, p. 282), we get an F-test statistic of 917 (1,708), which is highly significant, and the null hypothesis of no first-order autocorrelation is rejected. Tests developed by Pesaran (2004) and Frees

(1995) of cross-sectional independence are applied and both null hypotheses are rejected; this confirms the existence of cross-sectional correlation across regions.

Based on these diagnostic results, we used a fixed effect panel data model with correction for first-order serial correlation. We also estimated a feasible generalized least squares (FGLS) model with generalized error structure to allow for the presence of AR(1) autocorrelation within panels, as well as for heteroskedasticity and cross-sectional correlation across panels. By using three alternative model specifications we hope to provide information on the robustness of the results.

The fixed effect model is specified as

$$\pi_{it} = \alpha_i + X_{it}'\beta + \varepsilon_{it} \qquad i = 1,...,N; t = 1,...T. \tag{2}$$

where α_i represents the individual regional effect. The fixed effect model is typically estimated by the least squares dummy variable (LSDV) method (Greene 2003, p. 287).

The FGLS estimation method takes into account heteroskedasticity, and cross-sectional and serial correlation. The error terms can be written as

$$E[\varepsilon\varepsilon'] = \Omega = \begin{bmatrix} \sigma_{11}\Omega_{11} & \sigma_{12}\Omega_{12} & \cdots & \sigma_{1N}\Omega_{1N} \\ \sigma_{21}\Omega_{21} & \sigma_{22}\Omega_{22} & \cdots & \sigma_{2N}\Omega_{2N} \\ \vdots & \vdots & \ddots & \vdots \\ \sigma_{N1}\Omega_{N1} & \sigma_{N2}\Omega_{N2} & \cdots & \sigma_{NN}\Omega_{NN} \end{bmatrix}$$

where

$$\Omega_{ij} = \begin{bmatrix} 1 & \rho_j & \rho_j^2 & \cdots & \rho_j^{T-1} \\ \rho_i & 1 & \rho_j & \cdots & \rho_j^{T-2} \\ \rho_i^2 & \rho_i & 1 & \cdots & \rho_j^{T-3} \\ \cdots & \cdots & \cdots & \ddots & \cdots \\ \rho_i^{T-1} & \rho_i^{T-2} & \rho_i^{T-3} & \cdots & 1 \end{bmatrix}$$

An FGLS panel data model is also called the Parks-Kmenta method (Kmenta 1986). This method consists of the following steps. Estimate equation (1) by regular OLS. Then use the estimation residuals to estimate assumed error AR(1) serial correlation coefficient ρ. Use this coefficient to transform the model to eliminate error serial correlation. Substitute $\hat{\Omega}$ for Ω using estimated ρ and σ^2 then obtain the FGLS estimator of β as

$$\hat{\beta}_{GLS} = (X'\hat{\Omega}X)^{-1}X'\hat{\Omega}^{-1}y.$$

Analysis of Estimation Results

Using the relative gasoline price as the dependent variable, we get estimation results for the pooled OLS regression, a fixed effect panel data model, and a panel FGLS method; these are shown in Table 1. The corresponding estimation results for 3:2:1 crack spread are shown in Table 2.

In the case of the relative gasoline price, three estimation methods generate similar results. The only difference is that standard errors of coefficient estimates get bigger after taking into account cross-sectional and temporal autocorrelation, which in turn lead to a comparatively lower significance level for corresponding variables. Crude oil and gasoline inventories, refinery capacity, short-run supply disruption, and dummy variables for some summer months all significantly influence the relative gasoline price. Ethanol production has a considerably negative impact on the gasoline price, which is highly significant at the 1 percent level in all three estimation results. This indicates that over the sample period, ethanol has a significant substitution effect on gasoline. Evaluating at the sample mean, we find that the gasoline price is lowered by 39.50¢, 28.70¢, and 34.10¢ per gallon because of the substitution effect of ethanol.

For the 3:2:1 crack spread, the estimation results of the fixed effect and panel FGLS models are quite different from that of the pooled OLS regression. In addition, the pooled OLS regression model generates highly significant estimates for all explanatory variables except the dummy variables for January, February, and November. As previously mentioned, ignoring cross-sectional and serial correlation as well as individual heterogeneity typically leads to highly inaccurate standard error estimation; i.e., the significance estimation results are not reliable. Hence, we focus on the fixed effect and panel FGLS estimation results.

From these two sets of estimates, all the explanatory variables have intuitively correct signs. First, the profitability represented by the 3:2:1 crack spread presents a strong seasonal pattern. This is reflected by the fact that the dummy variables for months in the second and third quarters are all significant at the 1 percent significance level in the panel FGLS model and at the 5 percent level in the fixed effect model. Second, crude oil and refinery product market conditions, refinery capacity, ethanol production, and unexpected supply disruption significantly affect profit margins. For all five PADD regions, unexpected supply disruption, measured by dummies for Hurricanes Katrina and Rita, considerably increased profits in the months right after the occurrence. Gasoline imports and the HHI are found not to have statistically significant effects on crack spread nationally. Finally, we find that ethanol production generates negative pressure on crack spread over the sample period. For the fixed effect and panel FGLS models, the marginal effect of ethanol production on the crack spread is estimated to be -0.000073 and -0.000077, respectively.

Regional Analysis

Pooling cross-sectional and time-series information provides more accurate estimation results. However, it is instructive to analyze the time-series data of each region individually. Each PADD region has unique supply and demand conditions of crude oil and refinery products, different market structures, and different ethanol production and usage. The effects of explanatory variables may differ considerably because of region-specific factors.

We apply regular OLS regression on individual region's monthly data series over the period 1995 to 2007. The estimation results for the relative gasoline price and 3:2:1 crack spread are summarized in Tables 3 and 4, respectively.

From the estimation results for the relative gasoline price, ethanol production has a significant negative effect on gasoline prices in all regions. And the magnitude of the effect varies with PADD regions, ranging from -0.000041 to -0.000095. As expected, in PADD II, the Midwest region, ethanol production has the largest impact on the gasoline price with a coefficient of -0.000095. The substitution effect is highly significant and reduces the gasoline price by 39.5¢ on average over the sample period. The West Coast and East Coast experience similar negative ethanol impacts with estimates of -0.000056, which means that the corresponding gasoline price is lowered by 23.3¢. The Gulf Coast region, PADD III, has a slightly higher coefficient estimate of -0.000059, or, equivalently, a 24.6¢ reduction in gasoline prices. The Rocky Mountain region, or PADD IV, experienced the smallest downward gasoline price change, at 17.1¢, probably because of its comparatively low total gasoline consumption. These results tell us what would have happened had we removed the entire ethanol industry at the mean of the data set, and they are not marginal effects of removing one unit of ethanol capacity in each region.

From the estimation results of the profit margin for individual regions, effects of some explanatory variables differ considerably across regions. In PADD regions III and V, the HHI has a significant positive effect on refinery profit. This result suggests that higher market concentration in these two regional markets results in refinery profits. We did not find this pattern in our panel data model. Similarly, gasoline imports have a significant negative effect on the profit margin in both East Coast and Midwest regions, possibly because these two regions are more heavily dependent on imported refinery products to meet their regional demand. Ethanol production has a significant negative effect on the refiner's profit margin in all five PADD regions.

Conclusions

We employ pooled OLS regression, a fixed effect panel data model, and a panel FGLS estimation method to quantify the possible impact of ethanol on regular gasoline in the United States as a whole and in five regions of the United States. The models control for gasoline imports, refinery capacity, capacity utilization rate, hurricanes, market concentration in the refinery industry, stocks, and seasonality.

Estimation results show that over the period 1995 to 2007, ethanol production had a significant negative effect of $0.29 to $0.40 per gallon on retail gasoline prices. The results suggest that this reduction in gasoline prices came at the ex-

pense of refiners' profits. These results are statistically significant across a range of model specifications and across all regions.

Results for individual U.S. regions indicate that the largest impact of ethanol on gasoline is found in the Midwest region where gasoline prices were reduced by 39.5¢ per gallon. The Gulf Coast region is found to have experienced a 24.6¢ reduction in the retail gasoline price, while for the West Coast and East Coast, the average price drop is about 23.3¢. The smallest impact, a 17.1¢ reduction, is found in the Rocky Mountain region, mainly because of its comparatively low gasoline consumption.

These reductions in retail gasoline prices are surprisingly large, especially when one considers that they are calculated at their mean values over the sample period. The availability of ethanol essentially increased the "capacity" of the U.S. refinery industry and in so doing prevented some of the dramatic price increases often associated with an industry operating at close to capacity. Because these results are based on capacity, it would be wrong to extrapolate the results to today's markets. Had we not had ethanol, it seems likely that the crude oil refining industry would be slightly larger today than it actually is, and in the absence of this additional crude oil refining capacity the impact of eliminating ethanol would be extreme. In addition, the impact of the first billion gallons of ethanol on this capacity constraint would intuitively be greater than the billions of gallons that came later. We did try a quadratic term to pick up this effect, and it was not significant.

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TABLE 1.—REGRESSION RESULTS FOR POOLED OLS, THE FIXED EFFECT MODEL, AND THE PANEL FGLS METHOD ON RELATIVE GASOLINE PRICES

Variable	Pooled OLS Regression		Fixed effect model with AR(1)		Panel FGLS method	
	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error
Oil stock	[1] 3.88e-6	8.42e-7	[2] 1.97e-6	9.28e-7	[1] 5.71e-7	2.19e-7
Gasoline stock	[1] –5.03e-6	1.11e-6	[1] 0.000010	2.70e-6	[2] 1.03e-6	5.24e-7
Refinery capacity	[1] –0.000099	0.000029	[2] –0.00038	0.00019	[3] –0.00040	8.94e-6
Utilization rate	–0.0019	0.0028	0.00095	0.0015	0.00048	0.00041
Ethanol production	[1] –0.000095	3.96e-6	[1] –0.000069	0.000012	[1] –0.000082	0.000012
Supply disruption	[1] 0.32	0.11	[1] 0.20	0.055	[2] 0.20	0.099
Gasoline import	[1] –0.000037	3.89e-6	[1] 7.37e-6	2.75e-6	6.22e-6	4.78e-6
HHI	[1] 0.00028	0.000062	–0.00019	0.00019	–0.000037	0.000025
January	–0.030	0.054	[2] –0.047	0.022	0.015	0.035
February	–0.083	0.054	[2] –0.058	0.028	0.00061	0.046
March	0.013	0.055	–0.0079	0.031	0.031	0.053
April	[2] 0.12	0.055	0.055	0.035	0.069	0.058
May	[1] 0.19	0.056	[2] 0.089	0.036	[3] 0.099	0.060
June	[1] 0.17	0.055	[1] 0.10	0.037	[3] 0.10	0.060
July	[2] 0.11	0.055	0.046	0.036	0.020	0.059
August	0.046	0.055	0.029	0.034	–0.0084	0.056
September	–0.0077	0.054	–0.012	0.031	–0.060	0.052
October	–0.014	0.054	–0.014	0.026	–0.069	0.046
November	–0.032	0.053	–0.0063	0.019	–0.05	0.034
Constant	[1] 3.12	0.29	[1] 3.20	0.076	[1] 2.46	0.12
R^2	0.6014	.....	$\rho = 0.87$	.....	.....	.....
Adjusted R^2	0.5914	.....	F test	9.42	.....	.....

[1] 1 percent significance.
[2] 5 percent significance.
[3] 10 percent significance level.

TABLE 2.—REGRESSION RESULTS FOR THE POOLED OLS, THE FIXED EFFECT MODEL, AND THE PANEL FGLS METHOD ON THE 3:2:1 CRACK SPREAD

Variable	Pooled OLS Regression		Fixed effect model with AR(1)		Panel FGLS method	
	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error
Oil stock	[1] 4.61e-6	9.53e-7	[1] 7.27e-7	3.19e-7	1.7e-6	1.18e-6
Gasoline stock	[1] –4.56e-6	1.26e-6	1.13e-6	7.55e-7	[1] 0.000011	3.48e-6
Refinery capacity	[1] –0.000015	0.000032	[1] –0.000063	0.000012	[3] –0.00039	0.00022

Utilization rate	[1] –0.015	0.00032	–0.000066	0.00073	–0.00087	0.0019
Ethanol production	[1] –0.000091	4.49e-6	[1] –0.000073	0.000011	[1] –0.000077	0.000014
Supply disruption	[1] 0.32	0.12	[3] 0.23	0.13	[3] 0.13	0.071
Gasoline import	[1] –0.000062	4.41e-6	–3.3e-6	6.0e-6	5.19e-6	3.53e-6
HHI	[1] 0.00026	0.000069	–0.000027	0.000036	0.000079	0.00024
January	–0.058	0.06	0.00099	0.046	[1] –0.075	0.028
February	–0.075	0.06	0.022	0.059	–0.036	0.036
March	[2] 0.13	0.062	[2] 0.14	0.067	[2] 0.095	0.039
April	[1] 0.30	0.063	[1] 0.22	0.072	[1] 0.18	0.044
May	[1] 0.39	0.063	[1] 0.23	0.07	[1] 0.19	0.046
June	[1] 0.36	0.063	[1] 0.24	0.074	[1] 0.20	0.046
July	[1] 0.31	0.062	[2] 0.17	0.073	[1] 0.15	0.045
August	[1] 0.28	0.062	[2] 0.16	0.07	[1] 0.18	0.043
September	[1] 0.23	0.061	[3] 0.12	0.066	[1] 0.18	0.039
October	[1] 0.19	0.061	[3] 0.099	0.059	[1] 0.18	0.034
November	0.0022	0.060	–0.03	0.044	0.02	0.025
Constant	[1] 4.04	0.33	[1] 2.06	0.13	[1] 2.53	0.10
R^2	0.6196	.....	ρ = 0.87	.....	.....	.....
Adjusted R^2	0.6101	.....	F test	3.98	.....	.....

[1] 1 percent significance.
[2] 5 percent significance.
[3] 10 percent significance level.

TABLE 3.—RESULTS FOR OLS REGRESSION ON RELATIVE GASOLINE PRICE WITH INDIVIDUAL PADD REGIONAL DATA

Variable	PADD I		PADD II		PADD III		PADD IV		PADD V	
	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error
Oil stock	[3] .000025	.000015	[1] .000012	2.11e-6	[1] 3.89e-6	9.38e-7	–7.88e-6	.000018	2.84e-6	5.62e-6
Gasoline stock	[1] .000031	6.48e-6	.000011	8.16e-6	[1] .000024	7.36e-6	[1] .00015	.000055	.000029	.000019
Refinery capacity	0.0048	0.00032	.00054	.00047	–.00012	.00021	[1] –.0062	.0023	[1] –.0032	.00074
Utilization rate	0.0051	0.0046	–.012	.0073	[3] .010	.0056	–.010	.0086	.0037	.011
Ethanol production	[1] –.000056	.000014	[1] –.000095	8.45e-6	[1] –.000059	.000014	[1] –.000041	.000020	[1] –.000056	.000015
Supply disruption	[2] .47	.20	.19	.19	[1] .54	.20	.23	.26	–.069	.29
Gasoline import	[1] –.000044	7.58e-6	–.000012	9.59e-6	–5.07e-6	8.18e-6	–.000013	.000014	–9.37e-6	.000014
HHI	[3] –.00029	0.00017	–.00029	.00037	.00037	–.0030	.00051	.00053	[1] .0019	.00046
January	–.10	.097	–.047	.10	–.0057	.0084	–.14	.13	–.067	.15
February	–.11	.098	–.11	.10	–.024	.088	–.17	.13	–.0060	.15
March	.0079	.099	–.12	.11	–.006	.079	–.063	.12	.12	.14
April	.060	.10	–.013	.10	–.0044	.080	.15	.13	.22	.14

TABLE 3.—RESULTS FOR OLS REGRESSION ON RELATIVE GASOLINE PRICE WITH INDIVIDUAL PADD REGIONAL DATA—Continued

Variable	PADD I		PADD II		PADD III		PADD IV		PADD V	
	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error
May	.023	.11	.11	.11	.019	.080	[3] .26	.13	.22	.14
June	.000052	.10	.17	.11	.0097	.078	[2] .35	.14	.22	.14
July	.018	.10	.065	.10	–.0013	.078	[2] .33	.15	.16	.14
August	.072	.10	.093	.10	.017	.079	[2] .32	.15	.11	.15
September	–.037	.10	.053	.098	–.047	.076	.23	.14	.074	.14
October	.035	.10	–.012	.099	–.056	.077	.18	.13	.096	.14
November	–.029	.097	–.025	.096	–.052	.075	.09	.12	.046	.14
Constant	[1] 0.17	.67	.31	1.79	.048	1.20	[1] 5.56	1.49	[1] 8.87	2.79
R^2	.7109	.....	.7119	.....	.8229	.....	.6610	.....	.6415	.....
Adjusted R^2	.6705	.....	.6717	.....	.7981	.....	.6136	.....	.5915	.....

[1] 1 percent significance.
[2] 5 percent significance.
[3] 10 percent significance level.

TABLE 4.—RESULTS FOR OLS REGRESSION ON 3:2:1 CRACK SPREAD WITH INDIVIDUAL PADD REGIONAL DATA

Variable	PADD I		PADD II		PADD III		PADD IV		PADD V	
	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error	Estimate	Standard error
Oil stock	.000012	.000018	.000014	2.3e-6	[1] 4.9e-6	1.0e-6	.000017	.000019	[3] .000012	6.2e-6
Gasoline stock	[1] .000038	7.8e-6	[3] .000015	8.7e-6	[1] .000029	7.9e-6	[1] .000023	.000058	.000025	.000021
Refinery capacity	–0.000079	0.000038	–.00017	.00050	–.00028	.00023	[1] –.012	.0025	[1] –.0029	.000082
Utilization rate	[2] –.01	.0055	[1] –.031	.0078	[3] –.012	.0063	–.013	.0091	–.0065	.012
Ethanol production	[1] –.000051	.000017	[1] –.00009	9.e-6	[2] –.000039	.000016	–4.2e-6	.000021	[1] –.000047	.000016
Supply disruption	[2] .59	.24	.23	.21	.10	.21	.079	.27	–.24	.32
Gasoline import	[1] –.000065	9.1e-6	[1] –.000029	.00001	[2] –.000019	8.8e-6	–.000023	.000015	–.000019	.000016
HHI	–.00033	.24	–.00042	.00039	[1] –.0023	.000078	.00033	.00056	[1] .0016	.00050
January	–.098	.12	–.053	.11	–.13	.090	–.19	.13	–.11	.16
February	–.023	.12	–.098	.11	–.12	.10	–.17	.14	–.025	.16
March	.16	.12	–.069	.11	.05	.085	.044	.14	.22	.16
April	[3] .22	.12	.16	.11	.14	.086	[2] .34	.14	[2] .41	.16
May	.17	.13	[1] .33	.12	[3] .16	.086	[1] .46	.14	[2] .36	.16
June	.11	.12	[1] .41	.11	[3] .15	.084	[1] .59	.15	[2] .36	.16
July	.16	.13	[2] .28	.11	[3] .15	.084	[1] .62	.16	[2] .36	.16

August	[2] .25	.12	[1] .37	.11	[2] .21	.085	[1] .68	.16	[2] .38	.16
September	.14	.12	[1] .32	.10	[3] .14	.081	[1] .63	.15	[2] .40	.16
October	.20	.12	[3] .18	.10	.065	.083	[1] .53	.14	[2] .34	.16
November	.01	.12	.017	.10	−.053	.081	.21	.13	.068	.15
Constant	[1] 2.10	.81	[1] 3.76	1.91	[1] 3.52	1.29	[1] 7.22	1.58	[1] 8.04	3.07
R^2	.7017	.....	.7419	.....	.8299	.....	.7216	.....	.6592	.....
Adjusted R^2	.6600	.....	.7058	.....	.8061	.....	.6827	.....	.6116	.....

[1] 1 percent significance.
[2] 5 percent significance.
[3] 10 percent significance level.

NOVEMBER 2007.

ANALYSIS OF POTENTIAL CAUSES OF CONSUMER FOOD PRICE INFLATION

PREPARED FOR: THE RENEWABLE FUELS FOUNDATION

PREPARED BY: INFORMA ECONOMICS, AN AGRA INFORMA COMPANY

I. EXECUTIVE SUMMARY

A. Introduction

Since fall 2006, public debate has intensified over the extent to which the expansion of the ethanol industry has resulted in higher agricultural commodity prices and, more importantly, whether and to what extent there has been an impact on consumer food prices. To date, this debate has been fueled mainly by anecdotal information. Given that this issue has bearing on major policy decisions with respect to agriculture and renewable energy, it is imperative that an objective, fact-based assessment be available to public policymakers. The Renewable Fuels Foundation (RFF) commissioned Informa Economics, Inc. (Informa) to conduct such an assessment, and the results are contained in this report.

B. Key findings

The "farm value" of commodity raw materials used in foods accounts for 19 percent of total U.S. food costs, a proportion that has declined significantly from 37 percent in 1973. For food products where corn is only one of several farm-produced inputs, the proportion of the total product cost attributable to the cost of corn is even less than 19 percent. The remaining portion of total retail food costs is known as the marketing bill. The marketing bill includes the costs of labor, packaging, transportation, energy, profits, advertising, depreciation, rent, interest, repairs, business taxes, and other costs not attributable to basic agricultural commodities. The marketing bill has a higher correlation with the consumer price index (CPI) for food than does corn, although there is a notable long-term upward trend to both the marketing bill and the food CPI. Within the overall marketing bill, the costs of energy and transportation have increased considerably over the last several years, with crude oil prices surging from just under $60 per barrel in fall 2006 to nearly $100 per barrel in November 2007, the same period during which corn prices have increased.

An analysis was performed to quantify the historical price relationships between corn prices and livestock, poultry, egg, and milk prices, and the results showed weak correlations. With these low correlations, it is statistically unsupported to suggest that high and/or rising corn prices are the causative reason behind high and rising retail meat, egg, and milk product prices. Moreover, the upward trend in cattle, hog, and poultry prices began in the late 1990s, well before the corn price began to increase significantly. Notably, dairy and egg prices have been driven higher mainly by strong export demand.

More generally, there has historically been very little relationship between corn prices and consumer food prices. Statistical relationships are weak even when corn price data are lagged to allow time for them to work their way through the food supply chain. The corn price would be considered a statistically insignificant variable in determining what drives the food CPI.

To provide context to an analysis of consumer food prices, it is useful to consider the role of food expenditures in the average American's budget. The proportion of the average American's disposable income that is spent on food has declined steadily over the last half-century, from 21 percent of disposable income in 1950 to below 10 percent in 2006. Additionally, the share of total food expenditures accounted for by at-home food consumption has been declining relative to away-from-home consumption. In 1950, 83 percent of total food expenditures were for at-home consumption, but by 2006 this share had declined to 58 percent.

Consumer food prices have been increasing at a relatively steady pace over the last two decades. The annual increase in the food CPI has averaged 2.96 percent since 1985, with food price inflation peaking at 5.84 percent in 1989 and falling to 1.2 percent in 1992. Since 1992, the rate of increase in the food CPI has averaged a slightly lower 2.57 percent. By comparison, the annualized growth rate during the first three-quarters of 2007 has been 3.40 percent. While growth rates in the CPI sub-index for food consumed away from home have been slowly trending upward since about 1994, the CPI for food consumed at home is significantly more volatile and is currently growing more rapidly than away-from-home food prices.

The United States harvested a record corn crop of 11.8 billion bushels in 2004, but production fell to 11.1 billion bushels in 2005 and dropped further to 10.5 billion

bushels in 2006. Over the same time period, encompassing crop-marketing years 2004–2005 through 2006–2007, the usage of corn in ethanol production expanded to 2.1 billion bushels from 1.3 billion bushels. Yet, the ethanol industry was not the only source of additional demand for corn. U.S. corn exports, which were 1.8 billion bushels in 2004–2005, rose to 2.1 billion bushels in both 2005–2006 and 2006–2007—a level that was at the top of the range experienced over the previous decade. Thus, the combination of a reduction in supply and an increase in demand from both the ethanol industry and the export market led to corn prices moving higher starting in fall 2006.

Sub-indices of the food CPI are reported for the major food product categories. It was investigated whether the price of corn has a greater influence on these sub-indices than the overall food CPI. However, similar to the case with the overall food CPI, the relationship with the product sub-indices is generally weak.

Given the weak correlation between corn prices and consumer food prices, it can be hypothesized that a considerable proportion of the impact of corn price changes is absorbed by participants in the value chains for meats, poultry, and other corn-based food products. This does not necessarily mean that margins within the value chain are low or negative, but rather that they are lower than they would be in the absence of higher corn prices.

In summary, the statistical evidence does not support a conclusion that the growth in the ethanol industry is driving consumer food prices higher. This is demonstrated by the fact that the R-squared statistic between nearby corn futures prices on the Chicago Board of Trade (CBOT) and the food CPI is only 0.04, which means that only 4 percent of the change in the food CPI is "explained" by fluctuations in nearby corn futures prices. Even when the corn price is lagged to allow for the effects to work their way through the food supply chain, the statistical results do not improve. It can be concluded that no single factor is the driver of consumer food prices over time—or the moderately higher-than-average inflation during the first three quarters of 2007—but rather there is a complex and interrelated set of factors that contribute to food prices.

II. INTRODUCTION

Since fall 2006, public debate has intensified over the extent to which the expansion of the ethanol industry has resulted in higher agricultural commodity prices and, more importantly, whether and to what extent there has been an impact on consumer food prices. To date, this debate has been fueled mainly by anecdotal information. Given that this issue has bearing on major policy decisions with respect to agriculture and renewable energy, it is imperative that an objective, fact-based assessment be available to public policymakers. The RFF commissioned Informa to conduct such an assessment, and the results are contained in this report.

As a result of the confluence of several factors that are explained in Section VIII of this report, corn prices received by farmers increased to an average of $3.03 per bushel during the crop-marketing year that began in September 2006 and ended in August 2007, which was a substantial increase from the $2.09 per bushel that farmers received in August 2006, just before the start of the 2006–2007 crop year. Similarly, it was considerably higher than the $2.00 per bushel average experienced during the 2005–2006 crop year. However, other costs incurred in the production and distribution of food products were moving higher as well.

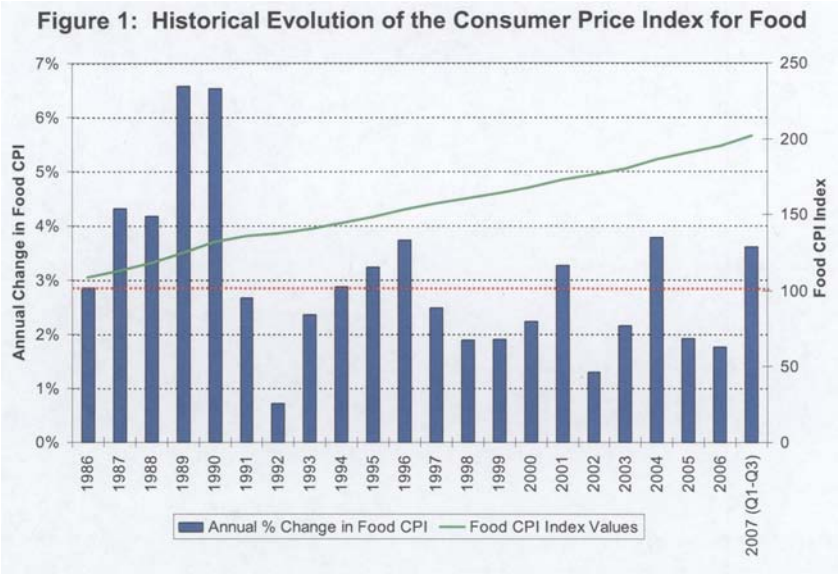
The price of crude oil (West Texas Intermediate) hovered just below $60 per barrel in fall 2006, then increased to the $60–$70 per barrel range in the spring and early summer of 2007 and further to the $70–$80 per barrel range in the late summer and early fall of 2007; in November 2007, the price surged to near $100 per barrel. Additionally, transportation costs have been surging in recent years, propelled higher partly by increasing fuel prices and partly by capacity tightness relative to strengthening demand for transportation services.

As will be shown in this report, no single factor is the driver of consumer food prices over time—or the moderately higher-than-average inflation during the first three quarters of 2007—but rather there is a complex and interrelated set of factors that contribute to food price inflation. In addition to the analysis contained in this report, Appendix A provides background on media coverage of the "food versus fuel" debate and on other studies that have looked into whether ethanol industry growth and changes in corn prices are contributing to food price inflation.

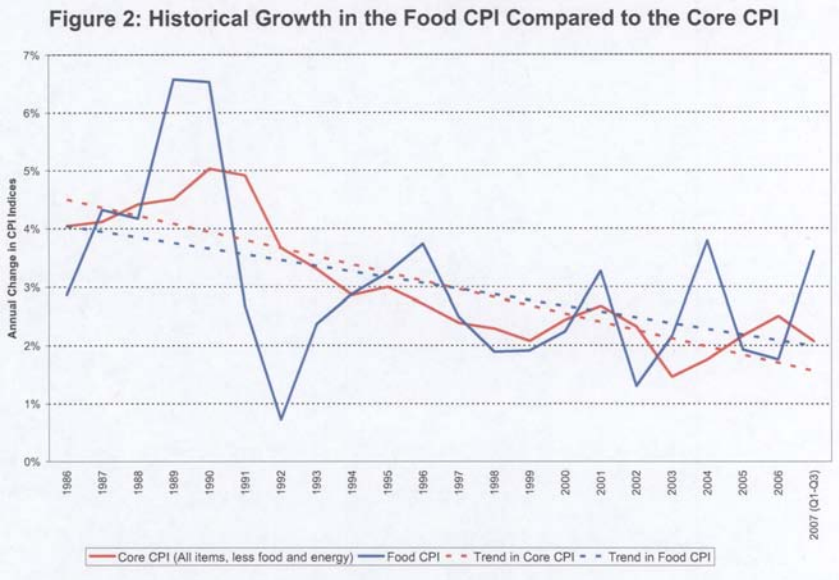
II. CONSUMER FOOD PRICES

Consumer food prices have been increasing at a relatively steady pace over the last two decades. Specifically, the annual increase in the food CPI has averaged 2.96 percent since 1985, with food price inflation peaking at 5.84 percent in 1989 and

falling to 1.2 percent in 1992 (see Figure 1). Since 1992, the rate of increase in the food CPI has averaged a slightly lower 2.57 percent. In comparison, the annualized growth rate during the first three-quarters of 2007 (January–September) has been 3.40 percent—a rate of growth that was matched only one other time in the last 15 years (in 2004).

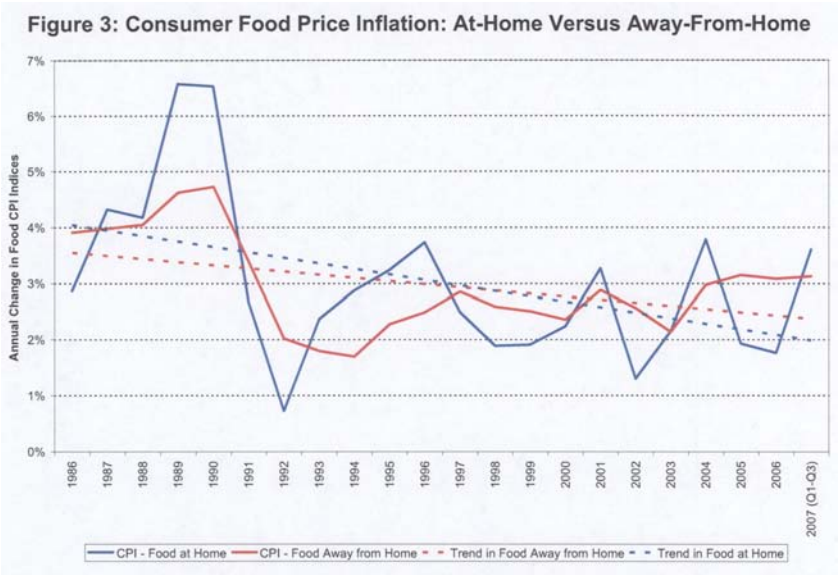


The "core CPI," which excludes food and energy prices, is viewed as a more accurate reflection of underlying inflationary pressures in the general economy than the overall CPI (at least in the short term), since the core CPI excludes food and energy prices, which tend to be significantly more volatile from month-to-month than other sectors of the economy. Over the 1985–2007 time period, the average annual inflation rate of the core CPI has been 3.09 percent, which is very close to the 2.96 percent average food CPI growth rate (see Figure 2). Whether inflation in the core CPI or the food CPI is higher varies almost from year to year.



If only the period since 1992 is considered, core CPI inflation has on average been 0.17 percent below food CPI inflation. Essentially, this again indicates food CPI inflation has been similar to the core inflation rate over the long run. During this time period, the greatest differential between the two CPI inflation rates was in 2004, when food CPI inflation was higher than core CPI inflation by 1.69 percent. Similarly, from January to September 2007, the food CPI inflation rate has been running 1.32 percent above the core CPI inflation rate.

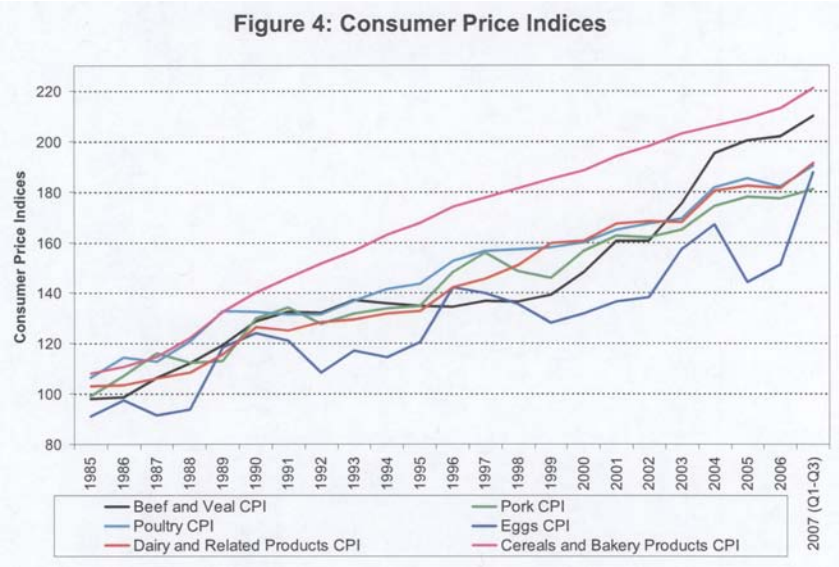
Not only is the overall CPI composed of major expenditure categories such as food and energy, but the food CPI is composed of two main sub-indices: food consumed at home and food consumed away from home. While growth rates in the away-from-home food CPI have been slowly trending upward since about 1994, the at-home food CPI is significantly more volatile and is currently growing more rapidly than away-from-home food prices (see Figure 3). However, both are currently growing at rates exceeding the core CPI.



Importantly, the USDA's Economic Research Service (ERS) and the Bureau of Labor Statistics (BLS) have noted that the at-home food CPI statistic likely overestimates actual inflation in prices consumers pay for food. This is due in part to the impact of emerging "big-box stores" (e.g., Wal-Mart and Costco) on the food at-home CPI. Data from previous studies have shown that food prices from these "big-box stores" are, on average, 7 percent to 8 percent lower than those found in large supermarket chains. The problem is that such stores might not be fully represented in the sample of stores surveyed for price data. Furthermore, when a "big-box store" acquires a store that is included in the surveyed group, the BLS has an aligning procedure which assumes that quality-adjusted prices at these stores are equal to the prices at the large supermarket chains. In essence, this procedure equates the prices of these alternative food retailers. A study by Hausman and Leibtag[1] concluded that this phenomenon confers an upward bias of 0.32 percent to 0.42 percent in the at-home food CPI.

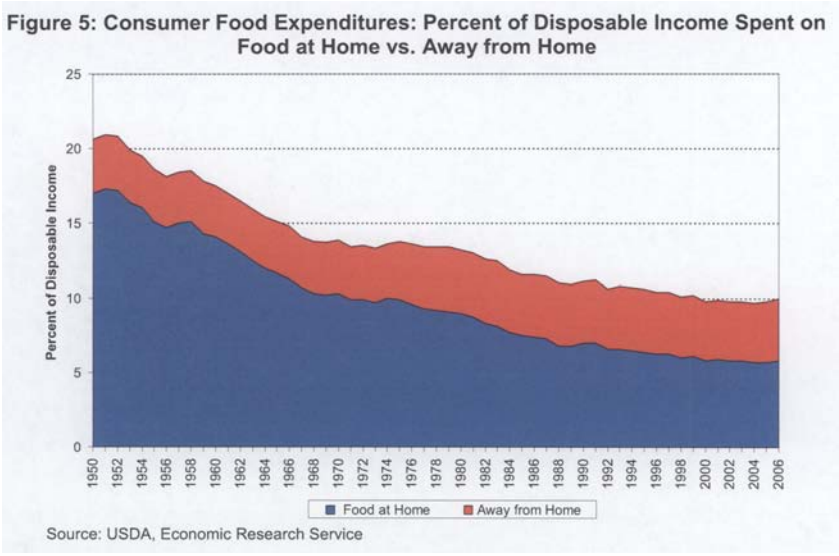
The at-home food CPI is further categorized into additional sub-indices, broken down into product categories with increasing levels of specificity. An evaluation of relevant first-level product categories further demonstrates which categories are largely responsible for changes in the overall food CPI. Among products that have a direct or indirect linkage to corn as an input, egg prices have recently been exhibiting the strongest inflation, while other livestock, dairy, and poultry markets exhibit similar, but much milder, trends (see Figure 4). In contrast, the CPI for cereals and bakery products has avoided the large, volatile swings that have occurred in the egg market. In general, the more value added in the manufacture of the product, the more consolidated the market, and the more price elastic the demand (i.e., costs cannot be passed along to consumers without lowering demand), the less volatile end-product prices will be.

[1] Hausman, J. and E. Leibtag. 2004. "CPI Bias from Supercenters: Does the BLS Know that Wal-Mart Exists?" NBER Working Paper #20712 (Aug). National Bureau of Economic Research, Cambridge, MA.



IV. PERSPECTIVE ON CONSUMER FOOD EXPENDITURES

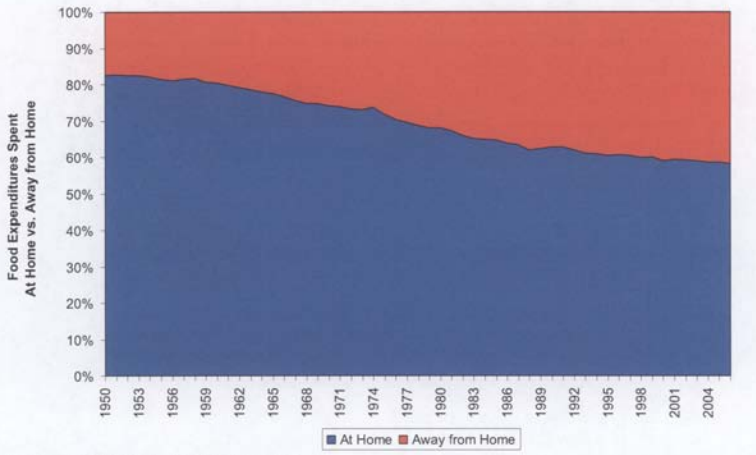
In providing context to the food-versus-fuel debate, in addition to examining how the CPI has changed over time it is also useful to consider the role of food expenditures in the average American's budget. To start with, the proportion of the average American's disposable income that is spent on food has declined steadily over the last half-century. In 1950, approximately 21 percent of disposable income was spent on food; by 2006, the share had broken below 10 percent (see Figure 5).



Interestingly, the proportion of disposable income spent on food away from home has remained relatively stable over time. Away-from-home food consumption has remained in the range of 4.0 percent to 4.3 percent of total disposable income since 1976. Given the increase in consumers' disposable income over time, this means that in nominal terms the total amount spent on food away-from-home has increased substantially. In fact, per capita away-from-home food expenditures have increased 44 percent between 2000 and 2006, increasing from an average $971 to $1,402.

Another trend within food expenditures is that the share accounted for by at-home food consumption has been declining relative to away-from-home consumption. Again, this is the share of food expenditures, whereas the previous paragraph addressed the share of disposable income. In 1950, 83 percent of total food expenditures were for at-home food consumption (see Figure 6). By 2006, this share had declined to 58 percent, and according to the USDA, it is predicted to fall to 51 percent by 2016.

Figure 6: Percent of Total Food Expenditures Spent at Home vs. Away from Home



Source: USDA, Economic Research Service

Increases in food prices in 2007 have been showing up more in the at-home food CPI than the away-from-home food CPI, which is to be expected since at-home food prices historically have been more volatile than away-from-home food prices (refer back to Figure 3). However, given that the at-home food category has been a declining component of total food expenditures, and that food expenditures have accounted for a declining proportion of consumer incomes, the effect of any increase in at-home food prices on the average American's financial condition will be considerably muted relative to what it would have been in the past.

In the Center for Agricultural and Rural Development (CARD) study referenced in the appendix to this study, long-run general food prices were predicted to increase by as much as 1.8 percent above the "no ethanol" scenario. This was the most extreme scenario of the reviewed research publications, as the USDA forecasts long-run food price inflation equal to or less than the general inflation rate, the AFBF found no short- or long-term relationship, and the consulting firm AES only reported inflationary increases for individual products. However, even though the inflation rates estimated by AES were only examined for individual products, for most product categories the rates were less than those estimated by the CARD study. Therefore, it can be said that this average retail food price inflation estimation of 1.8 percent above the "no ethanol" control is the highest inflation rate estimation of those referenced.

What would the scenario of 1.8 percent higher food price inflation mean for consumers? In 2006, the average disposable income was $32,114, with 9.9 percent of this being spent on food. This would mean that a 1.8 percent increase in the price food would increase the total annual food expenditures of an average household by about $57 a year. With 58 percent of this being spent on at-home food expenditures,

this means that the average American household can be expected to spend an extra $34 a year on their groceries.

However, to understand the net impact on consumers' financial condition, changes in expenditures on not only food but also fuel would have to be considered. Specifically, if more abundant supplies of ethanol were to result in a measurable reduction in retail fuel prices, this would have to be compared to any food price increase in determining the net impact to consumers. The effect of ethanol on retail fuel prices is not addressed in this study.

V. RELATIONSHIP BETWEEN CORN PRICES AND OTHER AGRICULTURAL COMMODITIES PRICES

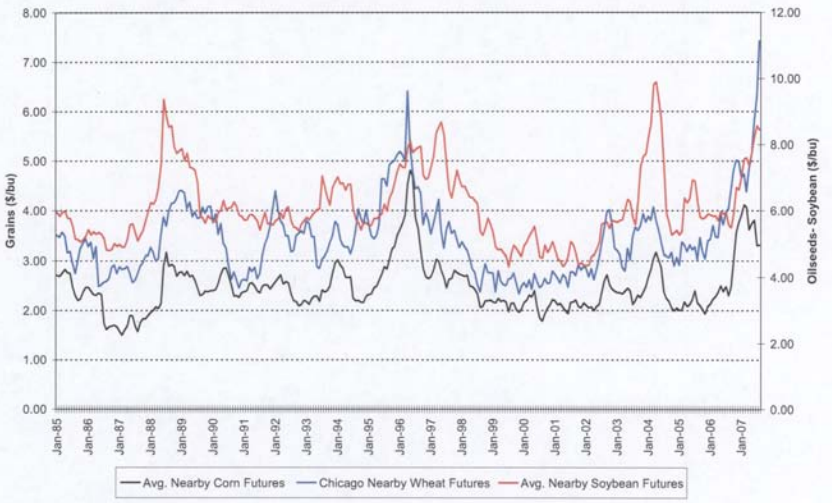
This section analyzes the relationships among the prices of corn, other commodities and consumer food prices. It examines whether there is a sufficient relationship between corn prices and other commodity and food prices to substantiate whether an increase in corn prices—regardless of the reason for the increase in corn prices—would cause an increase in the prices consumers pay for food.

A. Historical relationships among corn and other commodity prices

1. Grain and oilseed prices

Grain and oilseed prices have always been highly volatile. In Figure 7, historical monthly nearby futures averages are shown for corn, soybeans, and wheat, the three major row crops grown in the United States.[2] Until recently, domestic demand for these commodities generally grew at a relatively steady rate, while changes in supply (usually due to weather) have been the main determinants of price volatility.

Figure 7: Historical Grain and Oilseed Prices (January 1995 - August 2007)



Source: Chicago Board of Trade

While these three commodities have only limited substitutability for each other, conditions in one market can influence the prices in another—often caused by the common denominator of weather. Recent increases in corn prices are no exception. While a record corn crop is being harvested in the fall of 2007, there is concern that increased demand will bring soybean supplies down to low levels by the end of the crop year, and weather problems in Australia and other wheat-growing nations have caused wheat prices to reach record levels. As a result, corn prices have not been able to fall as would have been expected given the size of the crop. This section provides a brief overview of the complex historical relationships among these three markets.

[2] "Nearby" futures refer to the futures contract closest to expiration. For example, March futures would serve as the nearby corn contract during January and February of any given year, since contracts are not traded with delivery during those months.

The Corn Price.—Over the historical time period extending from January 1985 to August 2007, the average nearby corn futures price has averaged $2.46/bu. Weather had a substantial impact on corn futures prices in the 1988–1989 crop year, when poor crops resulted in high prices. (The crop year for corn begins in September, when harvest gears up on a large scale, and ends in August of the following calendar year.) In 1995–1996 record high corn prices were reached when a drop in production coincided with very strong export demand, resulting in record corn futures prices as high as $5.00/bu.

Following record corn production in the 2004–2005 crop year of 11.8 billion bushels and another crop over 11 billion bushels in 2005–2006, corn futures prices declined to $2.23/bu in the 2005–2006 crop year. However, driven by a significant decrease in corn acreage harvested in 2006, corn production fell to 10.5 billion bushels, while corn usage in ethanol production increased and exports rebounded strongly to the top end of the range experienced during the prior decade; as a result, nearby corn futures in 2006–2007 increased to an average $3.56/bu, with spring prices approaching the $4.50/bu range.

A fundamental driver of the price of corn is the level of inventories at the end of the crop-marketing year. Ending stocks are viewed by the industry as the "cushion" or "buffer" stocks available to incorporate increases in demand or reductions in supply in the following crop year. The larger the level of ending stocks, the more comfortable the market will be with a given level of demand. In particular, the ratio of year-end stocks to total consumption during the year is a key price determinant. Corn prices tend to weaken when supplies are plentiful relative to usage, whereas they strengthen when stocks are drawn down compared to demand. The level of stocks is market driven, as the U.S. Government no longer carries large stocks as part of its corn support programs.

Price Relationships Among Corn, Wheat, and Soybeans.—As was shown above in Figure 7, a general price relationship exists among these three crops. In 1995, the early frost that affected corn production also led to spikes in soybean and wheat prices. Just as the corn price increases were compounded by strong export demand, the wheat price increase was also compounded by other factors. These included low stocks that year and world supply issues, as production and export subsidies in the United States and EU were curtailed under the Uruguay Round of the General Agreement on Tariffs and Trade (now called the World Trade Organization, WTO).

However, a weather problem for one crop does not necessarily always mean a supply problem for the other. A prime example of this is the drought of 2003, which affected the soybean crop but left the other two crops relatively unscathed. While weather plays a key role in explaining the relationship between these three commodities, it is not the only factor. Each market has its own set of supply and demand factors that can either exacerbate the problems in another market or help to mitigate potential price increases.

Higher corn prices can influence wheat prices, but typically the reverse has not been true. This is because as corn prices move higher, wheat prices will be pulled higher to keep wheat from being used as a feed. However, the record wheat prices of 2007 are very much a result of supply-side issues. U.S. wheat supplies were reduced by adverse weather, including a spring freeze and unseasonably heavy rainfall around harvest. To add to the global supply problems, Australia's wheat production has fallen significantly due to drought. Eastern Europe, Ukraine, and to some extent Canada—all of which are large-scale wheat producers—have also been having supply issues.

In general, the demand bases for wheat and corn are quite different since the crops' end-product uses are generally different, with corn mainly used as a feed grain and wheat mainly used as a food grain. Usually, the global wheat supply has a modest impact on corn exports, although for countries where wheat and barley are the primary feed grains, a weather problem can necessitate increased usage of other feed grains, including imported corn. Although there can be some linkage between the wheat and corn markets in such a case, corn futures prices are remaining at high levels in fall 2007 in order for corn to "compete" against high-priced soybeans for acres to be planted in spring 2008; this competition is mainly with soybeans as opposed to wheat, since wheat is typically grown in areas that are not necessarily best suited for corn.

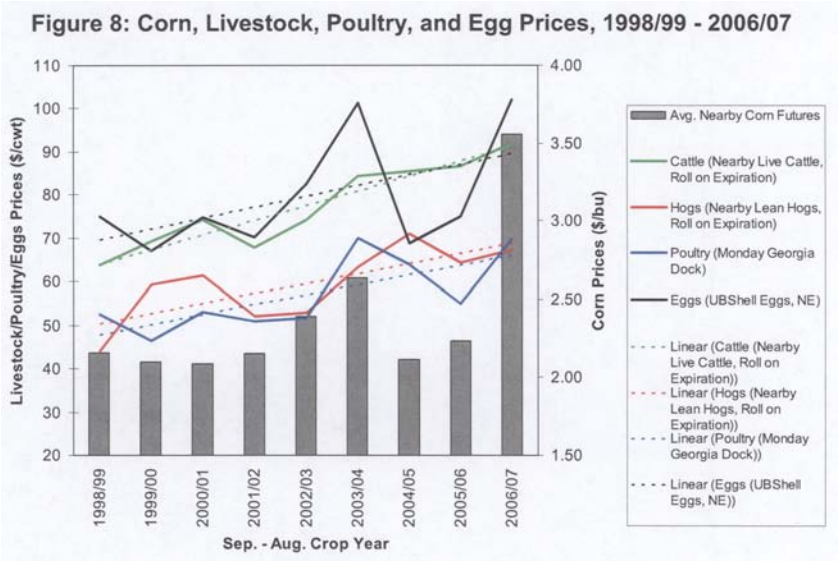
This competition between corn and soybean acres has affected the price relationship between these two commodities over the last couple of years. In the spring of 2006, futures prices provided a net revenue premium to grow soybeans compared to corn, and soybean acres expanded at the expense of corn. In 2007, the reverse was true, and corn acreage increased substantially. After the 2007 crop was made, the market realized that the pace of usage would bring soybean inventories to low levels at the end of the 2007–2008 crop year, and if a larger soybean crop were not

realized next year, the inventory situation would become particularly acute by the end of the 2008–2009 crop year. This has led to inflation in the corn price over what it would have been had it not had to compete with soybean acreage.

While part of the increase in soybean prices can be attributed to the shift of some soybean acres to corn in 2007, it can be argued that the price of soybeans would not have gone quite so high had it not been for the price of crude oil (petroleum), which has driven soybean oil prices higher due to the growth of the biodiesel industry.

2. Livestock, poultry, egg, and milk prices

Figure 8 provides a visual indication that there is not a strong correlation between corn prices and livestock or poultry prices. It is also evident that the upward trend in cattle, hog, and poultry prices began in the late 1990s, well before the corn price began to increase significantly in 2005–2006.



Cattle prices have been on an upswing since the mid-to-late 1990s, resulting from declining cattle supplies and increasing demand. Cattle inventories declined from 103.5 million head in 1996 (January 1 inventories) to just under 95 million head by 2004, and there has been only a modest 2-million-head rebound since then. In conjunction with declining cattle inventories was an increase in beef demand that became evident in the late 1990s. Consumer preferences began to take a detectable turn; the previously held belief that beef was a health detriment began to moderate as consumers adopted diets that placed more emphasis on protein and less on carbohydrates. These shifts in supply and demand have been the main driving forces behind the increasing cattle prices, which have been rising at an average annual growth rate of about 3.6 percent since 1998. Previous (1985–1998) cattle price increases averaged just less than 1 percent.

In contrast to the strong growth in cattle prices, the growth in hog and poultry prices has been more moderate, although there have still been increases. Similar to cattle prices, an upward trend in hog prices can be detected beginning near the turn of the millennium. In recent years, annual productivity gains have continued at trend levels, even as industry structure has matured. The breeding herd has held relatively steady, at or slightly above 6 million head since 2000, with minor deviations from year to year. From the demand side, pork demand at the wholesale level has remained stagnant in the United States, while export demand has increased dramatically. In general, there appears to be very little relation between corn prices and hog prices, with the possible exception being in the 1996–1997 crop year when hog prices spiked following the large corn price spike in 1995–1996. While most of this increase is attributed to constrained supplies of pork that year, the large increase in corn prices the previous year (exceeding the recent corn price spike in 2006–2007) may have partially motivated these supply reductions.

Poultry prices remained relatively flat across the 1985–1986 to 1999–2000 time period, averaging $54.50/cwt. Since then, poultry prices have been trending upward at an average annual growth rate of 4 percent (averaging $67.86/cwt). Such price increases can be largely explained by increasing per capita poultry consumption. Further demand increases have been seen following the Avian Influenza found within Asia and Europe in 2003. Such demand increases, along with tight supplies, resulted in the record-high prices recorded during the 2003–2004 crop year. Then in 2005–2006, prices dropped back down as exports backed off as a result of the record prices.

Egg prices, on the other hand, have been relatively more responsive to corn prices. There are several reasons for this tighter relationship. First, while the egg industry supply chain is not as concentrated as the broiler industry, it is still relatively integrated and consolidated. These larger, integrated operations are able to make supply decisions and respond more quickly to changing input prices than small, independent laying operations. Second, demand for eggs is relatively inelastic, as they are a cheaper source of protein than meats or other livestock products and are used in a range of processed food products. This enables price changes to be passed on to consumers without affecting overall consumption severely.

Egg values have been extremely high in 2007. With production margins extremely poor during 2005 and into 2006, producers cut their laying flocks considerably. Consequently, egg production has fallen. The total number of eggs produced up to this point in 2007 is about 1.5 percent fewer than the number of eggs produced during the same time period in 2006.

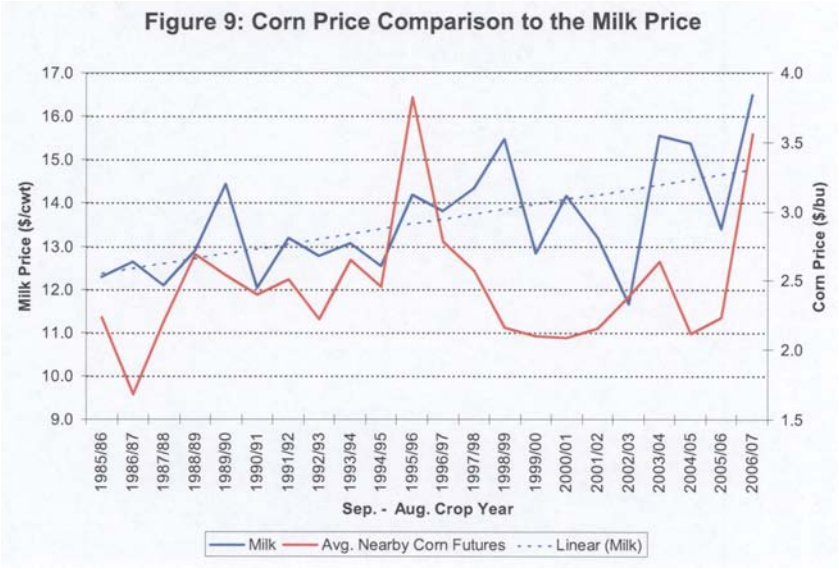
Along with a diminished U.S. egg supply, export trade of both eggs and egg products has risen strongly during 2007 (see Table 1). There has been a significant increase in exports of both shell eggs and egg products during the first 9 months of 2007 compared to recent years. Even though exports of shell eggs still account for less than 2 percent of all U.S. egg production, the increase in exports combined with diminished egg production was enough to skim necessary supplies from an already tight domestic market for eggs and has been a contributing factor to higher egg prices in 2007.

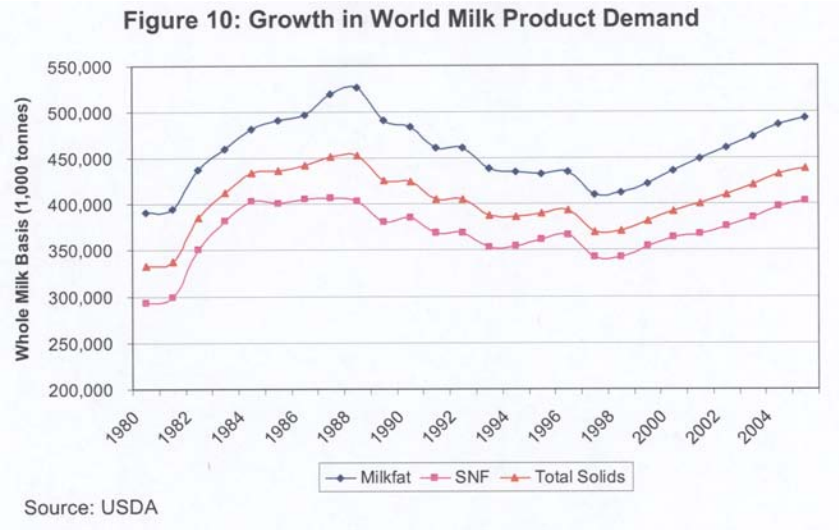
Similarly, inelastic demand for milk leads to a moderately tighter relationship between corn and milk prices than with other livestock and poultry prices (see Figure 9). That being said, recent milk price increases have been driven primarily by substantial increases in world dairy product demand and tight world supplies that resulted from major droughts in leading milk-producing countries, such as Australia (see Figure 10).

TABLE 1.—U.S. EXPORTS OF SHELL EGGS AND EGG PRODUCTS, JANUARY–SEPTEMBER, 2003–2007

Year	Table eggs (1,000 dozen)	Shell eggs (1,000 dozen)	All egg products, liquid equivalent (1,000 lbs)
2003 (January–September)	33,523	68,816	70,603
2004 (January–September)	36,123	73,157	61,195
2005 (January–September)	47,216	82,250	110,308
2006 (January–September)	37,838	75,478	114,536
2007 (January–September)	62,170	107,057	125,603

Note: Since only January–September data are available for 2007, data for the same time periods in previous years are shown for purposes of comparison.





Correlation analysis

An analysis was performed to quantify the historical price relationships between corn prices and livestock, poultry, egg, and milk prices, and the results showed rather weak correlations. With these low correlations, it is statistically unsupported to suggest that high and/or rising corn prices are the causative reason behind high and rising retail meat, egg, and milk product prices.

Quarterly average nearby corn futures prices were analyzed relative to quarterly average nearby cattle and nearby hog prices and quarterly cash price averages for broilers, milk, and eggs (January 1985–September 2007). Direct quarter to quarter correlations were calculated as were lagged correlations for one, two, three, and four quarters to identify if there was a lagged impact from corn prices on meat, egg, and milk prices. The results are presented below.

Cattle and beef

In the cattle-and-beef sector, the correlation coefficients were weak over short periods of time and even negative over longer periods of time, which indicates that there is no discernible strong relationship between corn prices and cattle prices (see Table 2). Based on this analysis, it can be concluded that high corn costs do not automatically result in higher cattle prices, either in the short term or over a 12–16 month period. The higher costs of producing beef result in a negative impact on cattle feeders' margins, and this ultimately would have a negative impact on feeder cattle prices (i.e., the prices paid animals entering feedlots). Irrespective of the price of corn, the price of fed cattle and beef might be higher or lower, with such prices determined by the supply/demand conditions in the beef market.

TABLE 2.—CORN/CATTLE PRICE CORRELATION COEFFICIENTS

	Correlation
Current	+0.18
One quarter lag	+0.15
Two quarter lag	+0.06
Three quarter lag	−0.06
Four quarter lag	−0.21

The cattle and beef industry has a rather complex supply chain, as numerous independent entities participate in the production of cattle as they progress from the core cow-calf production operation through backgrounding activities and then on through commercial cattle-feeding activities. In the production process for grain-fed beef, it can take anywhere from 16 to 24 months for an animal to move from birth to slaughter. Multiple buy/sell transactions occur in this process, as young calves are typically sold to operations that put these animals on forage programs and then eventually sell the animals to feedlot operations that feed out the animals to slaughter weights. The complexity of this process has a tendency of disrupting the supply response to changing cattle prices and changes in feed costs, which is likely reflected in the weak correlations between cattle and corn prices.

Hogs and pork

Within a single quarter there is virtually no correlation between corn prices and hog prices, as measured by nearby futures prices. Given the length of the breeding and production process (10–12 months), a lag of at least four quarters between high feed costs and any possible impact on hog prices would be anticipated. Historically, producers endured losses for at least two quarters prior to adjusting breeding inventories; if that behavior pattern still holds, there would theoretically be a relationship between corn prices lagged five or six quarters and hog prices. However, the correlations between corn prices and hog prices for all lagged time periods are very weak (see Table 3).

TABLE 3.—CORN/HOG PRICE CORRELATION COEFFICIENTS

	Correlation
Current	+0.15
One quarter lag	+0.19
Two quarter lag	+0.18
Three quarter lag	+0.17
Four quarter lag	+0.22
Five quarter lag	+0.19
Six quarter lag	+0.06
Seven quarter lag	−0.01

Even with a four-quarter lag on corn prices, the correlation of +0.22 is so weak that it cannot be concluded that higher corn prices result in higher hog prices. Once again, if higher corn prices were going to have an impact on pork supply and prices, such impacts would be expected at least a year from when corn prices rise. However, when further lags are considered (five, six, and seven quarters), the correlation actually begins to decline.

Broilers

In the broiler (chicken) sector, there does appear to be a slightly higher degree of linkage between broiler prices and corn prices. Still, correlation coefficients below

0.75 (actually, between −0.75 and 0.75) are considered tenuous at best, and the highest correlation coefficient between corn and the Georgia dock broiler price is only 0.3 (see Table 4).

TABLE 4.—CORN/BROILER PRICE CORRELATION COEFFICIENTS

	Correlation
Current	+0.25
One quarter lag	+0.31
Two quarter lag	+0.23
Three quarter lag	+0.12
Four quarter lag	+0.03

The coefficient of 0.25 within a single quarter indicates a weak relationship between corn and broiler prices. The fact that the coefficient with a one-quarter lag is a little higher does suggest that there is a very weak price relationship; however, over time the correlation coefficients get smaller (weaker), which indicates that there is little relationship between the cost of corn and the price of broilers.

Eggs

While correlations between corn and egg prices were the strongest observed for any of the livestock/poultry markets, the correlation coefficients would still be considered statistically weak. Again, a correlation between −0.75 and 0.75 is generally considered statistically insufficient to be used in modeling or predictions (for an equation with a single explanatory variable). Within a single quarter, or with up to a two-quarter lag in corn prices, the correlation coefficient between corn and eggs is gravitates around 0.5 (see Table 5). When a further lag in corn prices is considered, the correlations worsen.

TABLE 5.—CORN/EGG PRICE CORRELATION COEFFICIENTS

	Correlation
Current	+0.51
One quarter lag	+0.49
Two quarter lag	+0.51
Three quarter lag	+0.39
Four quarter lag	+0.13

Egg producers have the capability of adjusting short-term production volumes, which in turn can have fairly immediate impacts on egg prices. If corn prices were the driver of either "high" or "low" egg prices, the correlation coefficients would be substantially higher than those found and presented above. It would appear that other factors besides corn prices contribute to egg price changes. For example, egg-product exports have increased to 126 million pounds during the first 9 months of 2007, compared to 115 million pounds during the same period in 2006, which has resulted in high egg prices; the role of high corn prices appears to have been, at most, a secondary contributor.

Dairy and milk

Again, there is only a moderate degree of correlation between corn prices and milk prices (stronger than the broiler market but weaker than the egg market). The correlation coefficients for nearby corn futures prices and milk prices are shown in Table 6.

TABLE 6.—CORN/MILK PRICE CORRELATION COEFFICIENTS

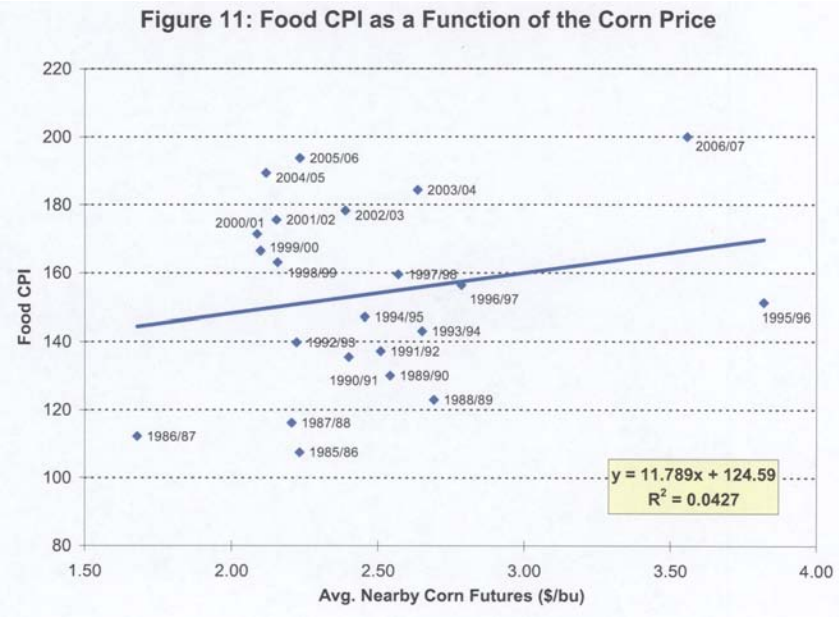
	Correlation
Current	+0.27
One quarter lag	+0.41
Two quarter lag	+0.44
Three quarter lag	+0.31
Four quarter lag	+0.13

VI. RELATIONSHIP BETWEEN CORN PRICES AND CONSUMER FOOD PRICES

A. Historical relationship between corn prices and consumer food prices

The first question to be asked in determining whether statements that higher corn prices are causing higher consumer food prices is: Have corn prices shown a strong relationship with consumer food prices in the past? In fact, this section shows there has historically been very little relationship between corn prices and consumer food prices. This is not surprising, given the results of the last section—if correlations between corn prices and livestock, poultry, egg, and milk prices at the wholesale level are weak, than correlations to further processed products at the retail level should be at least as weak.

Relationships between corn prices and consumer food prices were evaluated by running a simple regression of corn prices against food CPI index values. Crop year averages since 1985–1986 were utilized. The resulting R-squared [3] value was only 0.04, indicating that variations in the corn price "explain" only 4 percent of the variations in the food CPI index (see Figure 11). Thus, the corn price would be considered a statistically insignificant variable in determining what drives the food CPI.



In reality, it would be expected that a change in the corn price would take time to work its way through the value chain before the food CPI is affected, so that the impact might not be instantaneous. However, the R-squared values do not improve when quarterly prices are used and the corn price is lagged by as many as four quarters (see Table 7).

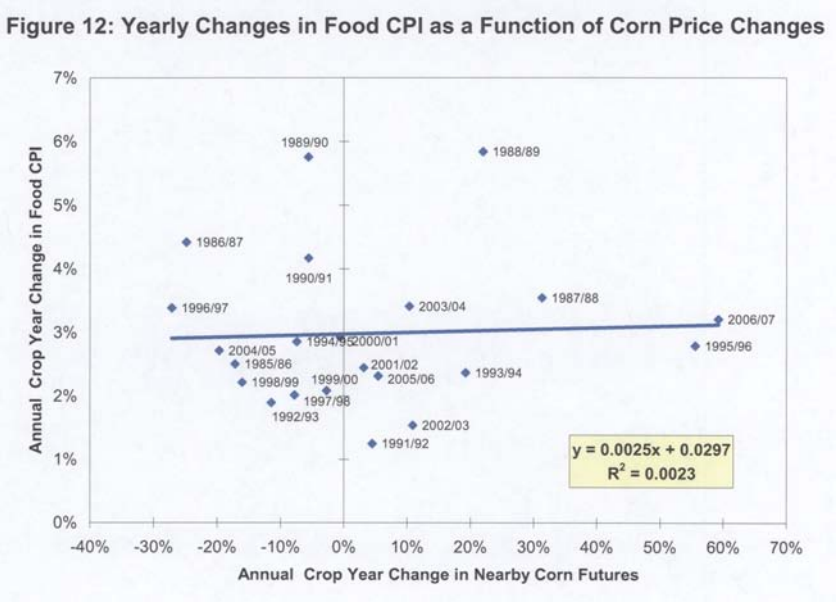
TABLE 7.—FOOD CPI AS A FUNCTION OF LAGGED CORN PRICES

Corn price	Correlation	R-squared value
Current	0.2010	0.0404
One quarter lag	0.1749	0.0306
Two quarter lag	0.1351	0.0183
Three quarter lag	0.0558	0.0031
Four quarter lag	−0.0078	0.0001

[3] The R-squared value represents the proportion of the total variation in the food CPI (the "y" variable) that can be explained by the corn price (the "x" variable).

Given that a general upward trend in the food CPI is prevalent, another regression was run using crop-year changes in corn prices against the crop-year changes in the food CPI. Again, very little of the food CPI inflation rate can be directly explained by year-to-year movements in the corn price, as reflected in an R-squared of 0.002 (see Figure 12). The corn price variable is statistically insignificant in the regression equation.

Figure 12: Yearly Changes in Food CPI as a Function of Corn Price Changes



While movements in the overall food CPI are not explained well by the price of corn, it was investigated whether the price of corn has a greater influence on subcategories within the food CPI. Similar to the case with the overall food CPI, the relationship with the product sub-indices is generally weak, with only eggs having an R-squared over 0.1 (see Table 8 and Table 9). This is true even if lagged corn prices are used.

TABLE 8.—CORRELATION BETWEEN FOOD CPI SUB-INDICES AND CURRENT/LAGGED CORN PRICES

Corn prices	Beef and veal CPI	Pork CPI	Poultry CPI	Eggs CPI	Dairy and related products CPI	Cereals and bakery products CPI
Current	0.1968	0.1701	0.2164	0.4163	0.1413	0.2186
One quarter lag	0.1534	0.1830	0.2286	0.0064	0.1435	0.2006
Two quarter lag	0.0947	0.1689	0.2078	0.3782	0.1243	0.1660
Three quarter lag	−0.0068	0.0939	0.1243	0.2936	0.0491	0.0919
Four quarter lag	−0.0798	0.0370	0.0427	0.1427	−0.0186	0.0321

TABLE 9.—R-SQUARED VALUES FOR FOOD CPI SUB-INDICES REGRESSED AGAINST CURRENT AND LAGGED CORN PRICES

Corn prices	Beef and veal CPI	Pork CPI	Poultry CPI	Eggs CPI	Dairy and related products CPI	Cereals and bakery products CPI
Current	0.0387	0.0289	0.0468	0.1733	0.0200	0.0478
One quarter lag	0.0235	0.0335	0.0523	.....	0.0206	0.0402
Two quarter lag	0.0090	0.0285	0.0432	0.1431	0.0154	0.0276
Three quarter lag	.....	0.0088	0.0155	0.0862	0.0024	0.0084
Four quarter lag	0.0064	0.0014	0.0018	0.0204	0.0003	0.0010

The value chain for eggs is relatively more consolidated than other product value chains, as there are fewer handlers; eggs also generally have less value added than other food categories, and their price elasticity of demand is highly inelastic. These are all potential reasons to explain the slight but notable correlation between the eggs CPI and the corn price. Still, this relationship is too weak to be statistically significant. Despite the fact that milk is also considered to be a highly price-inelastic product, a very weak correlation with corn prices (lagged or current) is exhibited.

Considering that there are trends in some food CPI sub-indices, an attempt was again made to determine whether there would be a more notable relationship between the annual crop-year percent change in the corn price and the annual crop-year percent change in the food CPI sub-indices. Again, the eggs CPI had the strongest correlation with corn prices, but the R-squared value was only 0.30; the corn price variable was statistically significant at the 5 percent level (the first regression where this was the case), but it still suggests that only 30 percent of the yearly movements in the eggs CPI can be attributed to yearly corn price changes (see Table 10). Other correlation and regression results indicate very weak price relationships—in some cases negative.

TABLE 10.—RELATIONSHIP BETWEEN ANNUAL CROP-YEAR CHANGES IN FOOD CPI SUB-INDICES AND CORN PRICE CHANGES

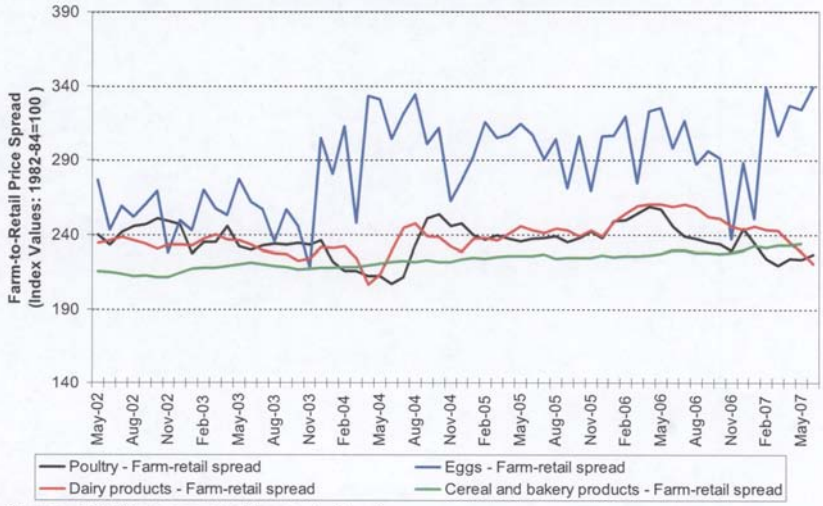
	Correlation	R-squared
Annual crop year percentage change in meats (beef and pork) CPI	−0.1078	0.0116
Annual crop year percentage change in beef and veal CPI	−0.0228	0.0005
Annual crop year percentage change in pork CPI	−0.1901	0.0361
Annual crop year percentage change in poultry CPI	0.0835	0.0070
Annual crop year percentage change in eggs CPI	0.5505	0.3031
Annual crop year percentage change in cereals and bakery products CPI	0.2756	0.0760

B. Price spreads among different levels of the value chain

There are several segments in the value chain between the farm and the consumer. For grains and oilseeds, there are grain elevators, bulk processors (e.g., flour millers and soybean crushers), further processors (e.g., packaged food manufacturers), wholesale distributors, and retail grocery and foodservice establishments that take basic commodities, transform them and deliver them to the consumer. For livestock and poultry, there are slaughterhouses and sometimes separate first-stage and further processors that produce in-tray meat cuts/poultry and packaged food products containing meats/poultry; distributors and retailers bring these products to consumers, while foodservice establishments prepare the meats/poultry before they are served.

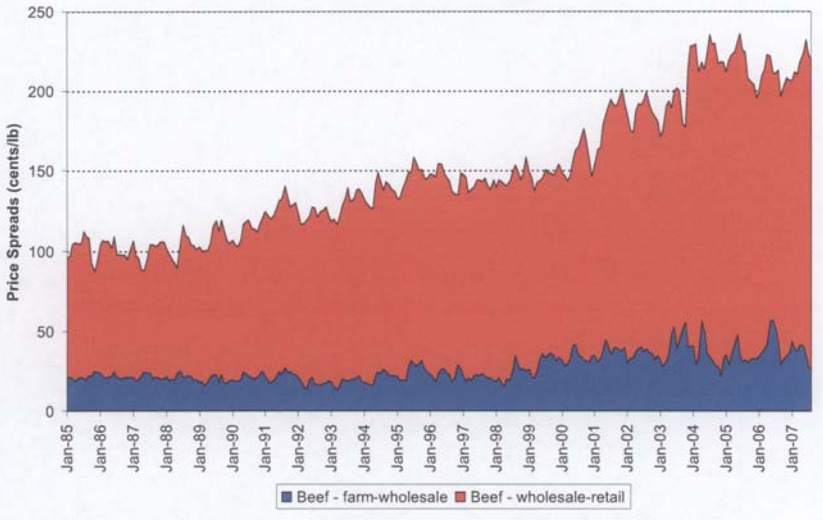
There are various economic factors (supply/demand and costs) and industry structure issues that determine the margins at each of these value-chain segments and the degree to which they can pass along cost increases. The historical price spreads from farm to wholesale and from wholesale to retail are shown in Figure 13 to Figure 15.

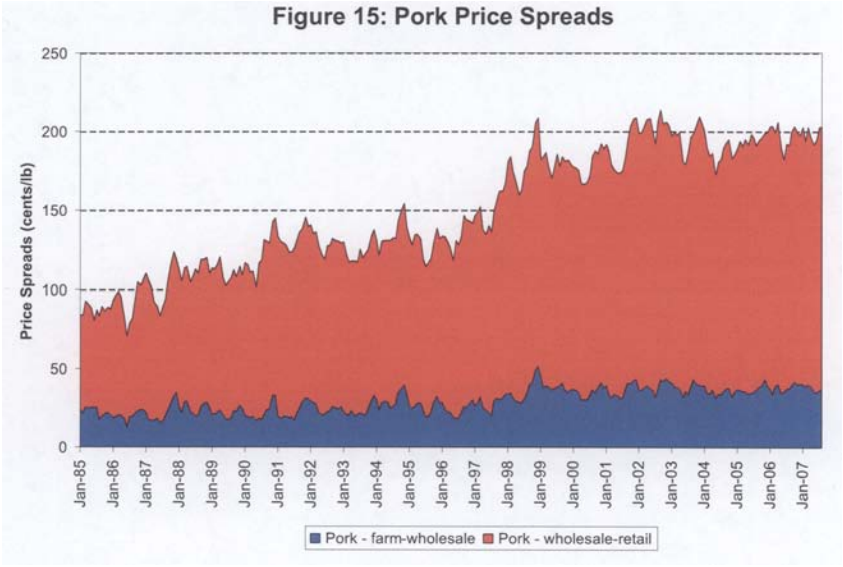
Figure 13: Farm-to-Retail Price Spreads



Source: USDA, Economic Research Service

Figure 14: Beef Price Spreads





C. Role of margins as shock absorbers

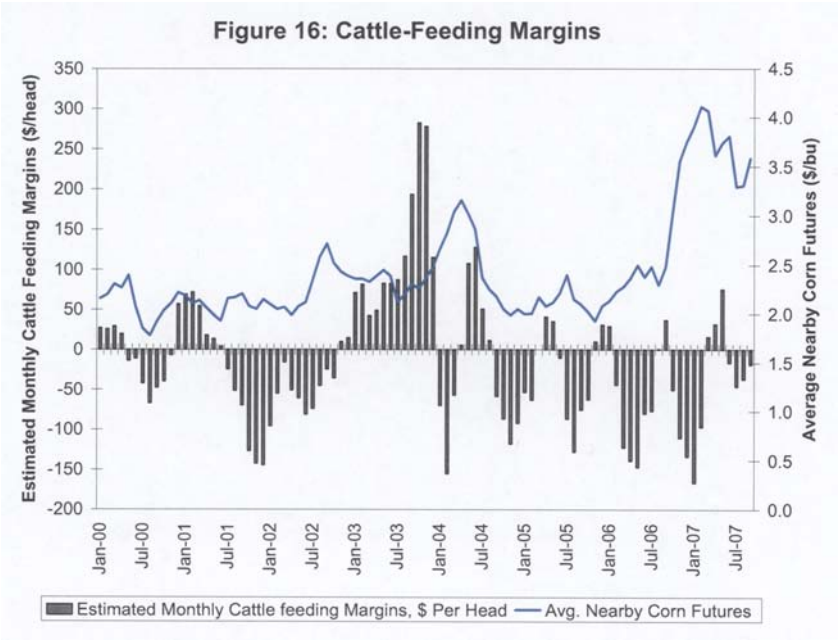
Given the weak correlation between corn prices and livestock, poultry, egg, and milk prices (at the farm level), it can be hypothesized that a considerable proportion of the impact of corn price changes is being absorbed in the value chain in the form of reduced margins to livestock producers. Importantly, this does not necessarily mean margins for livestock producers are low or negative, but rather that they are lower than they would be in the absence of higher corn prices. This section will look at the historical relationships between corn prices and production margins, as well as evaluate the impact of recent corn price changes.

1. Beef cattle

Cow-calf and cattle-feeding margins

Calf-crop levels have been declining steadily since about 1996, dropping from a level of 40.3 million head to 37.6 million head in 2007. During this same time period, a string of profitable years has been achieved in the cow-calf sector. Such strong profitability has not been experienced in the cattle feeding sector, where imputed margins have been negative since early 2004 (see Figure 16). This followed uncharacteristically high margins in 2003, which resulted mainly from the large increase in cattle prices during the last half of that year.[4] In fact, over the long term from January 1985 to August 2007, average cattle feeding margins were negative, by an amount of −$15.42/head. However, this does not necessarily mean that cattle feeders have experienced sustained losses over the time period, since there are many cost markups associated with feedlot operations that are already included in their margin calculations.

[4] Trade disruptions in the aftermath of the first domestic case of BSE in Canadian cattle helped boost United States fed cattle prices to record levels in the fall of 2003.



While total feed costs are undeniably affected by changes in the corn price, overall margins are not mirror-reflections of corn price changes. For one, there is often a lagged affect. The corn purchased in one period does not directly affect the profitability of the feeder steers being sold that period, but rather those that are being fed to be sold at a later date. Furthermore, cattle feeders anticipating higher corn prices will make operational adjustments. They will purchase fewer feeder cattle or only buy them at reduced prices; they can make ration adjustments to a degree; and/or they can decrease the number of days each animal is on feed (reducing total yardage costs and perhaps total feed consumption). The latter option is achieved by placing heavier-weight feeder cattle into the feedlot, or selling fattened cattle at a lower finished weight. There are also many other factors, such as beef demand, that affect the sales price of finished cattle but have nothing to do with the corn price.

Another mitigating factor has been the ability of feedlots to incorporate distillers grains into their feed rations. For each bushel of corn ground to make ethanol, almost one-third of the material ends up as distillers grains, and according to industry sources, approximately 42 percent of the distillers grains consumed in the United States in 2006 were used in beef cattle rations. Distillers grains are a high-energy, high-protein feed source that can be used as a feed substitute for corn. In fact, many recent feeding trials suggest that feeding wet distillers grains with solubles actually increases feed efficiency relative to corn.

Table 11 provides cost and revenue data for the U.S. cattle-feeding industry based on a proprietary feedlot production cost model developed by Informa. Annual data for calendar years 2004, 2005, and 2006 are presented. The key assumptions made are that feeder cattle are purchased and enter the feedlot at 750 pounds and are fed to a marketing weight of 1,200 pounds live, equivalent to 756 pounds carcass weight. The cost per head for feeder cattle entering the feedlot over this 3-year timeframe ranged from $774 in 2004 to $841 in 2006, with the 2005 cost very similar to 2006.

TABLE 11.—INFORMA FEEDLOT PRODUCTION COST MODEL

[Feedlot production cost model ($/head)]

Marketing year	Market cost on 750 lb feeder steer	Feed cost	Total costs in feedlot	Total cost of 1,200 lb feeder steer	Market value of 1,200 lb feeder steer	Difference	Steer carcass weight
2004	774.40	167.92	270.00	1,044.40	1,012.97	−31.43	807
2005	838.98	135.77	247.16	1,086.14	1,054.46	−31.68	816
2006	840.99	150.92	268.72	1,109.71	1,035.62	−74.09	833
		1,200 lb liveweight fed steer yields an average carcass weight of 756 lbs					

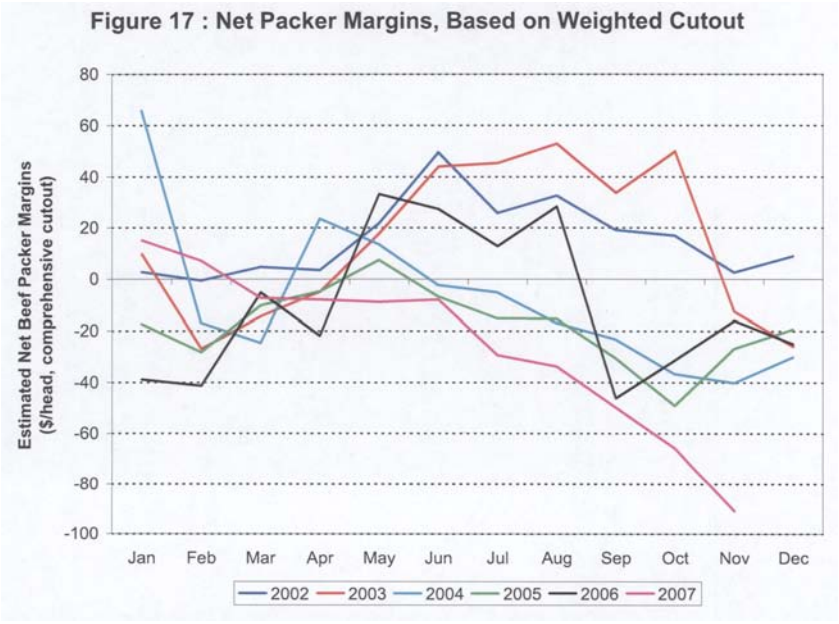
Source: Informa Economics, Inc.

Feed costs per head for 450 pounds of gain vary primarily with the cost of corn. Feed costs per head were about $168 in 2004, dropped to $136 in 2005 as corn prices declined, and then rebounded to about $151/head in 2006 as corn prices turned higher. Total costs per animal during the feeding period are also provided; most changes are directly related to the cost of corn. For the 3 years analyzed, the feed cost as a percent of total costs ranged from a low of 54.9 percent in 2005 to a high of 62.2 percent in 2004.

For information purposes, a calculation of the total cost of a 1,200 pound fed steer is provided along with the average market value for that same animal. As can be seen, margins for feeding these animals were negative in each year under study, with 2004 and 2005 losses amounting to just over $31/head while 2006 losses were more than double that at an estimated $74/head. Of note is the fact that even with a $32/head lower feed cost per head in 2005 relative to 2004, per-head production losses were the same in both years which, once again reflects the disconnect that exists between the cost of corn and the price of cattle.

Packer margins

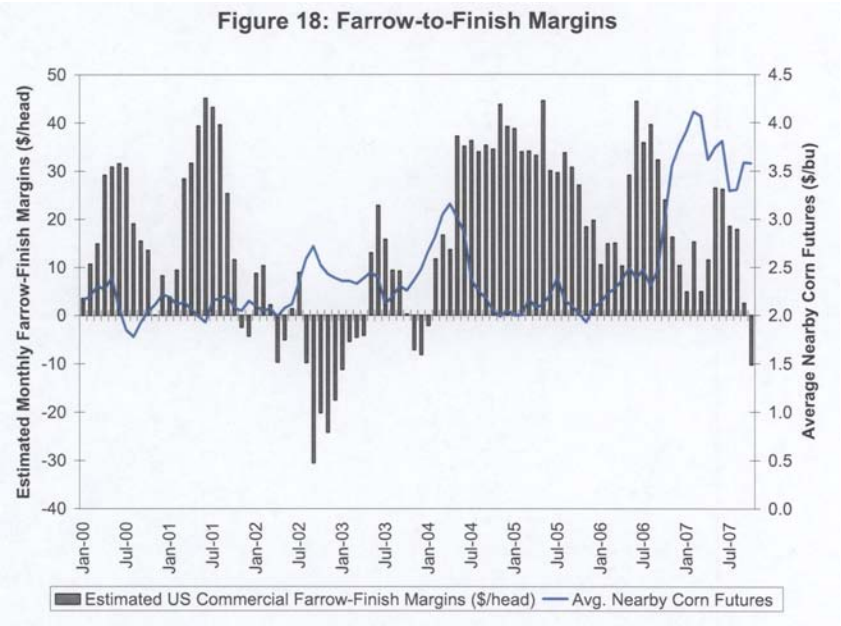
Packers have been experiencing the largest sustained losses of any of the beef supply chain participants. This has been a result of excess capacity chasing relatively tight supplies. Declining margins in the early 1990s forced plant shutdowns, and while margins improved in the mid-1990s, they have declined to historically low levels within the last 2 years. Figure 17 shows net packer margins since 2002.



2. Hogs

The hog industry has a much more integrated production system than the cattle industry, and as a result, pork production growth tends to be relatively stable, increasing at an average pace of 2 percent annually since 2000. Unlike cattle, hogs can not utilize forages, thus feed costs tend to account for a relatively large percentage of variable input costs.

Hog production margins remained high but volatile throughout most of the 1990s. However, in the late 1990s, producers expanded rapidly at the same time as the packing industry was reducing capacity, resulting in a huge price collapse in late 1998 and poor production margins for the next year. Production margins recovered in 2000 and 2001 only to turn negative during much of 2002 and 2003, as per capita pork supplies increased to burdensome levels once again (see Figure 18).



Beginning in late 2003, the U.S. pork industry began to experience an unprecedented boom in exports, which helped drive demand for pork and propel prices and margins to much higher levels. Since then, hog margins have remained mostly in the $20 to $30/head range, peaking periodically into the $40/head range and dropping down into the teens in early 2006. The run of profitability since 2004 has been the best on record. Then, starting in early 2007, as corn prices had begun to increase significantly, hog margins took a slight decrease down into the $5–$25/head range, as the higher cost of gain offset hog prices, which remained favorable up through the summer of 2007. In the fall of 2007, on large production increases, hog production margins finally began to turn negative, ending the longest uninterrupted run of profits on record for the industry.

In Table 12, the total production cost per hog is calculated and converted to a total cost per cwt lean; it then is compared to the annual average market value per cwt lean to give an indication of production margins. The 2004–2006 time period was the best ever in terms of profitability for the hog production sector. Given that the long-term average margin for producers would fall somewhere in the $7–$8/cwt lean range, the United States industry headed into 2007 with a strong equity and financial condition fully able to withstand potential margin pressures arising from higher corn costs.

TABLE 12.—HOG PRODUCTION COST MODEL

[Farrow to finish cost of production model]

	Feed cost $/ head	Total cost $/ head	Total cost per $/cwt lean	Market value per $/ cwt lean	Margin per cwt lean	Live weight	Carcass weight
2004	49.00	114.00	57.41	71.74	14.33	262.00	199.30
2005	37.00	103.00	51.09	68.28	17.19	264.00	200.70
2006	40.00	105.00	52.03	64.41	12.38	265.00	201.10
			Butcher hog fed to 265 pounds				

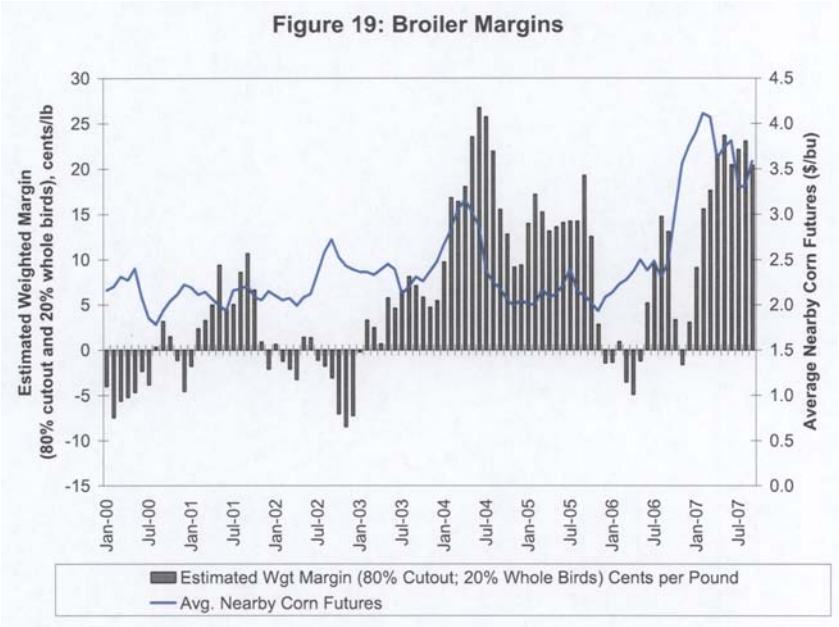
Source: Informa Economics, Inc.

3. Poultry: broilers and eggs

Broilers

The broiler industry is a highly integrated and concentrated industry with the top 25 production operations accounting for a large percentage of industry output. Since the decision making at the production level is consolidated into few hands, the broiler industry has the capability of making rather quick and meaningful production adjustment decisions.

There appears to be very little correlation between historical poultry margins and the price of corn (see Figure 19). In fact, when corn prices were at their lowest in early 2006, poultry margins were negative, and as corn prices began to take off, poultry margins climbed (although they took a brief dip when corn prices peaked in early 2007). In early 2003, poultry margins took a swing from negative to positive, despite relatively stagnant corn prices. This was a direct result from a cutback in production taken after the margin losses in 2002 and 2003. This cutback in production along with record high prices in late 2003 and early 2004 led to record high margins by mid-2004. Then, as exports dropped off due to the high poultry prices, margins began to decline. Corn prices throughout all of this have had relatively little effect. In fact, the record-high margins in mid-2004 directly followed a corn price spike in the preceding months.



As of November 2007, nearby CBOT corn futures were about $4/bushel, while soybean meal has been averaging near $220/ton. Based on these feed input prices, the feed cost per pound of broiler meat produced has risen to 25 cents compared to an

average of 20.6 cents in 2006. This appreciation in feed costs has raised total production costs to nearly 56 cents per pound. Even with this advance in feed costs, sales values for both whole birds and broiler parts are providing a weighted industry return of nearly 14 cents per pound (see Table 13).

With financial returns of this magnitude, odds favor the industry increasing production rather than maintaining the slight reductions that started last fall and lasted through the first quarter of 2007. The industry did initiate a production rollback in the fall of 2006 due to poor margins; the weak margin situation was due to weak product prices in combination with rising feed costs. The production declines were large enough to raise product prices, and now that sales values have recovered so too have margins.

TABLE 13.—BROILER PRODUCTION COSTS AND IMPACT OF HIGHER CORN PRICE

[U.S. broilers]

	Average liveweight	Average eviscerated weight	Feed cost per RTC pound	Other cost per RTC pound	Total cost per RTC pound	Whole broiler net returns per RTC pound	Cutout net returns per RTC pound	Weighted net returns (80 percent cutout, 20 percent whole broilers) per RTC
2004	5.27	3.82	22.58	30.84	53.43	21.24	16.45	17.41
2005	5.38	3.90	19.52	30.84	50.36	22.46	10.21	12.66
2006	5.47	3.96	20.60	30.84	51.45	16.80	0.00	3.36
2007 ($4.00/bu corn)	5.45	3.95	25.00	30.84	55.85	18.30	12.92	13.99
2007 ($4.50/bu corn)	5.41	3.92	27.49	30.84	58.33	7.06	−4.05	−1.83

Eggs

Table 14 provides estimates of shell egg production costs. The feed cost per dozen eggs produced has varied from a low of 23.95 cents per dozen in 2005 to a high of 27.54 cents in 2004. Costs in 2006 for the feed component of production costs averaged 25.49 cents per dozen. Based on shell egg selling prices in the past 3 years, margins have been rather variable. In 2004, margins averaged over 18 cents per dozen even though feed costs were high, helped by very firm egg prices. Lower feed costs in 2005 were accompanied by weak egg prices and margins slipped to 5.41 cents before recovering to 10 cents per dozen in 2006. As with other livestock sectors, changes in feed costs have not been correlated with producer margins.

TABLE 14.—EGG COST OF PRODUCTION MODEL

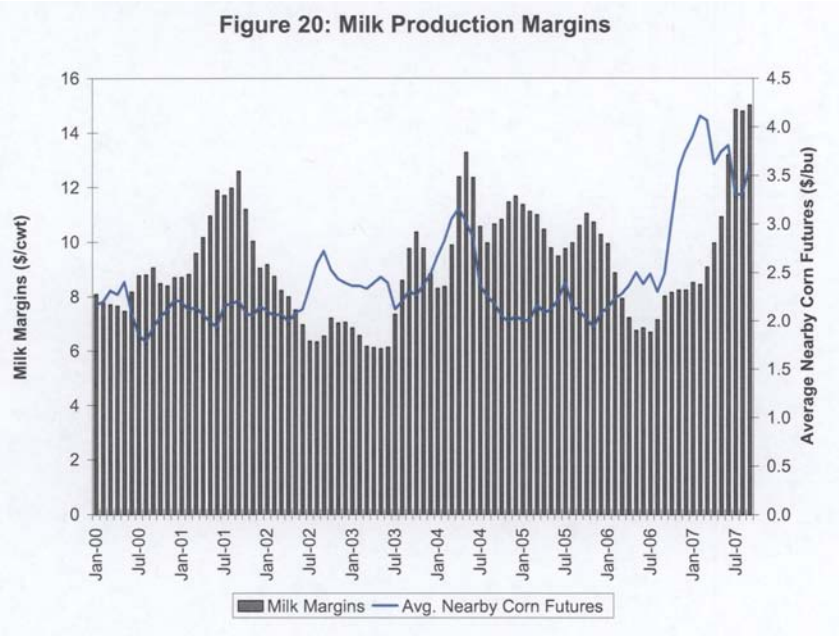
[Table egg cost of production model]

	Feed cost per dozen	Total cost per dozen	Margin per dozen	Urner Barry MW shell egg price
2004	$27.54	$49.80	$18.04	$86.54
2005	23.95	45.72	5.41	68.80
2006	25.49	47.37	10.00	75.44
$4.00 corn	32.61	55.25	20.90	92.71
$4.50 corn	34.75	57.75	18.40	92.71

Despite the highest feed costs in over 10 years, margins for the industry are the best in many years due to very strong egg prices. With average shell egg prices projected to be near 93 cents per dozen, production margins are very strong and this suggests the potential for expanding production rather than production declines.

4. Milk

Estimated milk production margins have averaged $9.35/cwt over the time period from January 2000 to September 2007. Milk margins declined in 2002–2003 when corn prices increased, but margins climbed as corn prices spiked in 2003–2004 (see Figure 20). Both corn prices and milk margins declined during the latter part of 2004 and most of 2005. Despite current corn prices taking off, beginning in early 2007, milk margins have climbed to record high levels. This suggests that corn prices are a very minor determinant of milk production margins and are not a primary driver of milk prices.



Milk margins have been strong the past year largely as a result of rising milk prices, which have been driven by demand increases. U.S. milk consumption is increasing, and world dairy demand is also increasing. This world demand increase follows strong economic growth in many developing countries, and it is compounded by the fact that many major milk-producing countries, such as Australia, have been experiencing drought, thus tightening world milk and dairy supplies. Due to this strong global demand, U.S. exports of dairy products have increased significantly, and this has supported domestic price increases of milk and milk products.

VII. DRIVERS OF FOOD PRICE INFLATION

Given that historical data shows little relationship between corn prices and consumer food prices, the question arises: What does drive consumer food prices? This section will explore various factors affecting consumer food price inflation. In summary, food price inflation is caused by a complex set of factors.

A. Summary of usda models of the food CPI

USDA–ERS periodically forecasts the food CPI, and it is frequently asked to evaluate the impact of input price changes. The agency has three different models it uses to analyze the food CPI, with the choice of model depending on whether or not the objective calls for an analysis of short-run or long-run impacts. The ERS price-spread model and input-output model are used to analyze short-run impacts, while the variable proportions model is used in long-run analyses.

The price-spread model uses a weighted sum of percent changes in input prices from 16 food industries to estimate input price change effects on at-home food prices, where each input change is weighted by its respective cost share. It is assumed that each firm in each of the 16 food industries produces a single end-product; accordingly, the model combines a farm commodity with a set of non-farm inputs in fixed proportions.

Alternatively, the input-output model, while similar to the price-spread model, considers the indirect effects of changing input costs. For example, an increase in energy will not only affect the cost of producing the food item, but it will also impact the costs of producing other food production inputs. This model uses a system of equations from 50 food industries and 430 nonfood industries. Both of the short-run

models assume that consumers do not respond to retail price changes and that food producers do not alter their input proportions.[5]

However, the long-run model, the variable proportions model, relaxes these short-run restrictions. This eight-market food model uses a system-of-equations approach: (1) the first equation relates the industry's retail price to the price of one marketing or non-farm input, the exogenous farm supply, and the shift in consumer demand; and (2) the second equation relates the industry's farm price with the same three variables. Analyses using the variable proportions model have shown that changes in input prices do not always lead to food price increases. This effect is mitigated by firms altering their input proportions and by changing consumer demand.[6]

The ERS lists four key factors as influencing how input cost increases affect food prices.[7] The first is the share of total costs accounted for by the input (this is discussed in detail below). The second is whether or not the input has adequate substitutes in the production process. the third is whether or not consumers have good substitutes for the food product. Last is the time period considered. In the short run, producers and consumers might not be able to adjust to price changes. If the price change is permanent, such adjustments can be made, but on the other hand, this might cause some firms to go out of business, causing the price increase to be greater in the long run.

B. Food marketing costs

1. Composition of the retail food dollar

The share of the final food product price accounted for by the cost of commodities purchased from producers has declined over the years. According to consumer expenditure data collected by the BLS and reported by the USDA, the "farm value" accounts for 19 percent of total food costs. This proportion has declined significantly from 37.2 percent in 1973 (see Figure 21).

The remaining portion of total retail food costs (i.e., in addition to the farm value) is known as the marketing bill. The marketing bill includes labor, packaging, transportation, energy, profits, advertising, depreciation, rent, interest, repairs, business taxes, and other costs.

With the decrease in the share of the food dollar accounted for by the farm value of raw materials, corn price changes have a declining impact on the overall food retail price. Furthermore, within many food items, corn constitutes only a portion of the farm value. Thus, in items where corn is only one of several farm inputs, total food costs attributable to the cost of corn will be on average even less than 19 percent.

While 19 percent represents the average share of farm value in the retail food dollar, this percentage varies considerably among food items. Table 15 provides the most current annual average data available for food categories for which the USDA estimates the farm value share of the retail food price.[8]

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[5] This may be a rather strong assumption, especially for certain food products in which demand is elastic, there are multiple substitute products available to consumers, or for which there are substitute products available within the production process.

[6] Reed, A.J., K. Hanson, H. Elitzak, and G. Schluter. 1997. "Changing Consumer Food Prices: A User's Guide to ERS Analyses." Technical Bulletin #1862. Economic Research Service, Washington, DC.

[7] Economic Research Service. 2007. "Food CPI, Prices, and Expenditures: How Changes in Input Costs Affect Food Prices." Retrieved from *www.ers.usda.gov/Briefing/CPIFoodAndExpenditures/howchangesininputcostsaffectf*.

[8] The most recent annual average data available for cereals and bakery products, fats and oils, and dairy were for 2005. Annual averages were available for 2006 for meat product data.

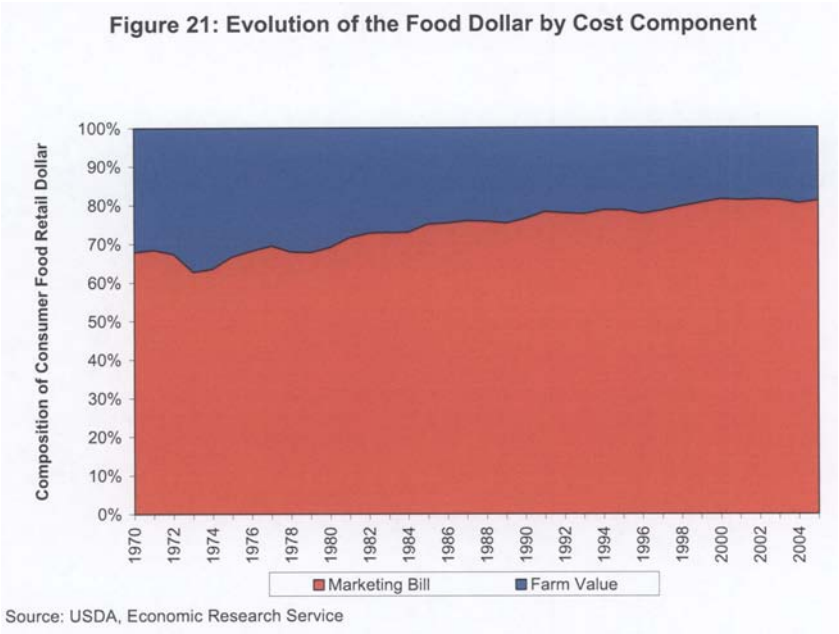


TABLE 15.—FARM VALUE SHARE OF RETAIL FOOD PRICE BY FOOD CATEGORY

Food product category	Farm value as percentage of retail price
Cereals and bakery items	6
Beef	47
Pork	30
Chicken	36
Dairy products	36
Fats and oils	17

The farm value share of the food dollar is provided for specific food products rather than categories in Table 16. The product examples that were selected for the table either are derived from corn or are commodities affected by the corn market (e.g., livestock, poultry, wheat, and soybeans). Again, total farm-based input costs are shown, not only the cost of corn.

TABLE 16.—EXAMPLES: COST OF FARM INPUTS AS A SHARE OF PRICES OF SELECT RETAIL FOOD PRODUCTS

Food product	Farm value share of retail price (percentage)	Example retail prices (price per pound)	Cost of input(s) purchased from farm (price per pound)
Milk, ½ gal.	34	$3.84	$1.31
Flour, wheat, 5 lbs	19	0.36	0.07
Bread, 1 lb	5	1.21	0.06
Margarine, 1 lb	15	1.26	0.19
Corn flakes, 18 oz. box	4	1.65	0.07
Corn syrup, 16 oz. bottle	3	1.57	0.05
Ground beef, 1 lb	47	2.37	1.11
Bacon, sliced	28	3.78	1.06
Chicken, fresh whole	47	1.14	0.54

Sources: USDA, ERS (utilizing most current data available for each food product category, as of October 2007)

VIII. PERSPECTIVE ON COMMODITY PRICE INFLATION

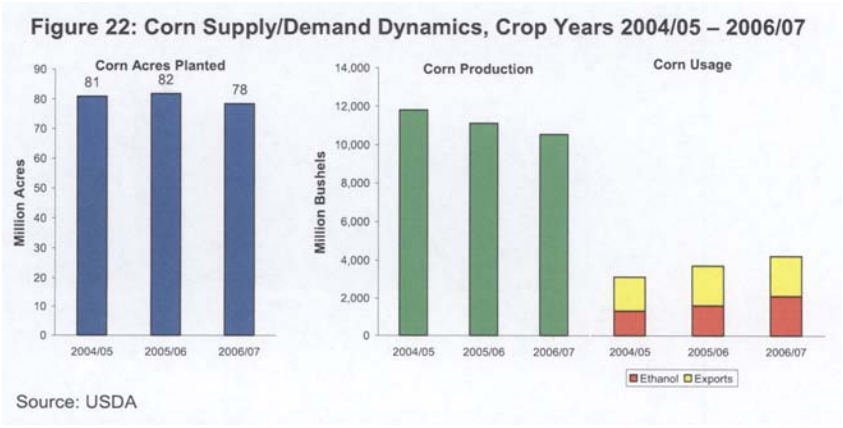
Although it has been shown in the preceding sections of this report that corn price changes have, at most, a weak correlation with changes in the food CPI, additional context can be provided to this report by examining not only the higher corn prices that have occurred since fall 2006 but also the environment of general commodity price inflation in which this has been occurring.

A. Corn prices

The "conventional wisdom" expressed in the media is that a dramatic increase in the use of corn in ethanol production caused corn prices to increase substantially, particularly since the fall of 2006. However, even the reason for the increase in corn prices is more complex than indicated by the media.

Fueled by a record yield, the United States harvested a record corn crop of 11.8 billion bushels in 2004. In 2005, acreage remained steady, but a more historically consistent yield led production to fall to 11.1 billion bushels. Then, in the spring of 2006, price signals in the futures markets gave farmers the incentive to plant more soybeans, and the acreage planted to corn fell by 3.5 million acres. Combined with relatively flat yields, corn production fell for the second year in a row, to 10.5 billion bushels.

Thus, corn production fell by 1.3 billion bushels over 2 years, even though the usage of corn in ethanol production expanded from 1.3 billion bushels in 2004–2005 to 2.1 billion bushels in 2006–2007 (see Figure 22). Yet, the ethanol industry was not the only source of additional demand. U.S. corn exports, which were 1.8 billion bushels in 2004–2005, rose to 2.1 billion bushels in both 2005–2006 and 2006–2007—a level that was at the top of the range experienced over the previous decade. So, it was basic supply and demand—a reduction in supply and an increase in demand from both ethanol and exports—that led to prices moving higher in the fall of 2006.



Then, in 2007, U.S. farmers proved that they could respond to the market's need for more corn. In the 1996 and 2002 Farm bills, producers had been relieved of the base-acre and set-aside systems that had previously restricted what they could plant, and they now had "freedom to farm"—the ability to allocate their crop acreage as they saw fit, with few remaining constraints. With this freedom and corn prices that provided a significant net revenue premium per acre over soybeans, farmers planted 93.6 million acres of corn in 2007—the highest level since the 1940s. As of November 2007, the USDA estimates the crop at a record 13.2 billion bushels (see Table 17).

As was mentioned earlier in this report, the level of corn stocks at the end of the crop year relative to the volume of corn consumed during the year is a key factor in the pricing of corn. At the end of 2004–2005, when the previous record crop was harvested, the stocks-to-use ratio was nearly 20 percent, which is plentiful by recent historical standards. However, with lower production and rising ethanol usage and exports, the stocks-to-use ratio was cut almost in half, to just under 12 percent, in 2006–2007. This was reflected in substantially higher prices.

Despite Informa's projections of an almost 800-million-bushel increase in the corn grind for ethanol and an additional 250 million bushels of exports, the record crop

of 2007 is forecast to allow stocks to build to over 2.1 billion bushels by the end of the crop year, allowing the stocks-to-use ratio to rebound to 17.1 percent. Normally, this would be expected to allow prices to ease significantly. However, soybean oil prices have been lifted by rising crude oil (petroleum) prices, and as a result the pace of soybean consumption is expected to bring stocks to meager levels by the end of the 2007–2008 crop year, and if there is not a rebound in soybean acres planted in 2008 stocks could reach unsustainably low levels. This has led to upward pressure on soybean prices, and in order for corn acreage not to fall too far in the face of continued ethanol industry expansion—and likely continued strength in exports given weakness in the U.S. Dollar—the market has maintained relatively high corn futures prices.

Based on futures prices as of November 2007, farmers would be expected to plant nearly 89 million acres of corn in 2008. If this were to occur, Informa's forecast of the stocks-to-use ratio for 2008–2009 would be 16.5 percent, which is ample but not burdensome. The national average farm price for corn, which Informa forecasts to be $3.25/bu in 2007–2008 would be forecast to fall to $2.85/bu in 2008–2009 under this scenario.

However, absent a very favorable soybean yield in 2008, such a high level of corn plantings would likely not allow soybean production to be sufficient to prevent stocks from falling to an unsustainable level, and prices would have to rise even further to ration demand. Accordingly, it is expected that by the spring of 2008 the market will anticipate this imbalance, and corn acres will be reduced further, with balance perhaps occurring at roughly 86 million acres of corn. In this case, even with no change in the demand forecast, the stocks-to-use ratio for corn would be forecast to recede to 12.7 percent in 2008–2009, which would be sufficient and would allow corn prices to come down.

TABLE 17.—U.S. CORN BALANCE SHEET

	97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09
Planted acres	79.5	80.2	77.4	79.6	75.7	78.9	78.6	80.9	81.8	78.3	93.6	88.9
Harvested acres	72.7	72.6	70.5	72.4	68.8	69.3	70.9	73.6	75.1	70.6	86.1	81.8
Yield	126.7	134.4	133.8	136.9	138.2	129.3	142.2	160.4	148.0	149.1	153.0	160.0
Beginning inventories (September 1)	883	1,308	1,787	1,718	1,899	1,596	1,087	958	2,114	1,967	1,304	2,117
Production	9,207	9,759	9,431	9,915	9,503	8,967	10,089	11,807	11,114	10,535	13,168	13,083
Imports	9	19	15	7	10	14	14	11	9	12	10	10
Total supply	10,099	11,085	11,232	11,639	11,412	10,578	11,190	12,776	13,237	12,514	14,482	15,209
Feed and residual	5,479	5,469	5,665	5,842	5,864	5,563	5,795	6,158	6,155	5,598	5,700	5,400
Food/seed/industrial	1,805	1,846	1,913	1,957	2,047	2,340	2,537	2,686	2,981	3,488	4,290	5,500
Of which: ethanol for fuel	481	526	566	628	706	996	1,168	1,323	1,603	2,117	2,900	4,100
Domestic use	7,284	7,316	7,578	7,799	7,911	7,903	8,332	8,844	9,136	9,086	9,990	10,900
Exports	1,507	1,983	1,937	1,941	1,905	1,588	1,900	1,818	2,134	2,124	2,375	2,150
Total use	8,791	9,298	9,515	9,740	9,815	9,491	10,232	10,662	11,270	11,210	12,365	13,050
Ending inventories (August 31)	1,308	1,787	1,718	1,899	1,596	1,087	958	2,114	1,967	1,304	2,117	2,159
Stocks/use (percent)	14.9	19.2	18.1	19.5	16.3	11.4	9.4	19.8	17.5	11.6	17.1	16.5
Futures price ($/bu)	2.57	2.16	2.10	2.09	2.15	2.37	2.64	2.12	2.23	3.54	3.55	3.25
Farm price ($/bu)	2.43	1.94	1.82	1.85	1.97	2.32	2.42	2.06	2.00	3.03	3.25	2.85

Sources: USDA, CBOT (History); Informa Economics.

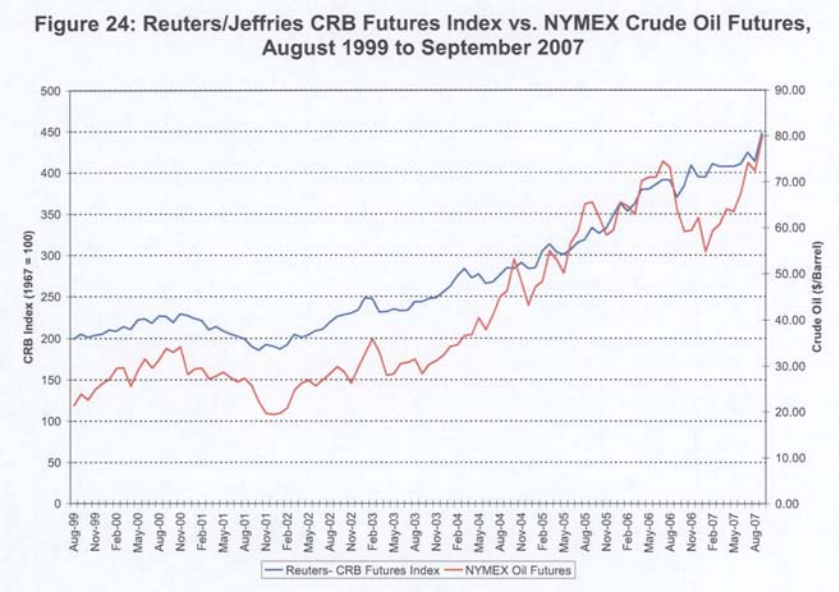
Thus, producers have demonstrated their ability to respond swiftly to market conditions in making their acreage decisions. Assuming normal weather, this ability and willingness to shift acres is expected to mitigate any further inflationary pressures on corn prices through at least the 2008–2009 crop year, despite expectations for continued rapid growth in the ethanol industry. As a final note, there is evidence that the biotech corn traits that were first introduced in the United States in 1996 and have been gaining broader adoption in recent years have led to the potential for above-trend yields to be achieved; to the extent that this occurs or technology developments accelerate, this would further mitigate any upward pressure on corn prices.

B. General commodity and macroeconomic inflation

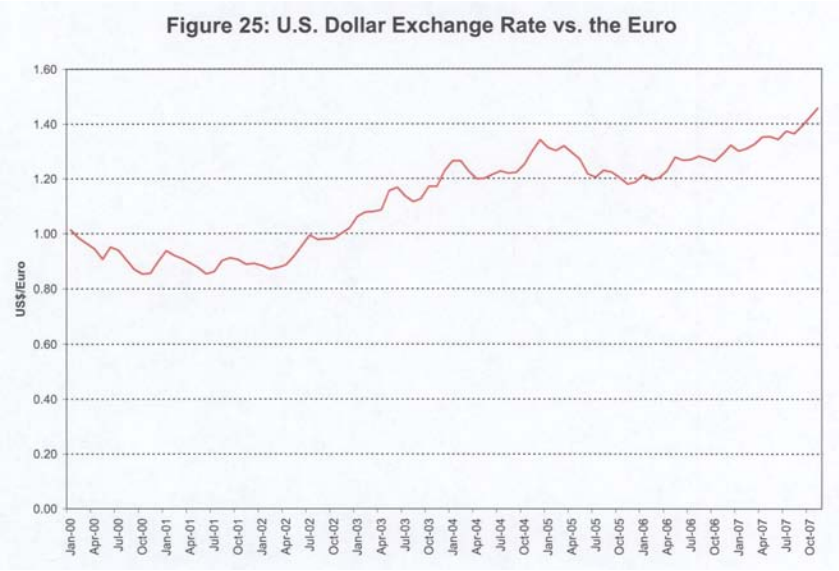
The increase in corn prices since the fall of 2006 is not occurring in a vacuum, and in fact the Reuters/Jeffries CRB index, an index of commodity prices, has more than doubled since 2001 (see Figure 23). The index is a weighted average of the prices of 19 commodities in three categories: energy, agriculture, and metals.

Figure 23: Monthly Average Reuters/Jeffries CRB Futures Index, January 1970 - September 2007

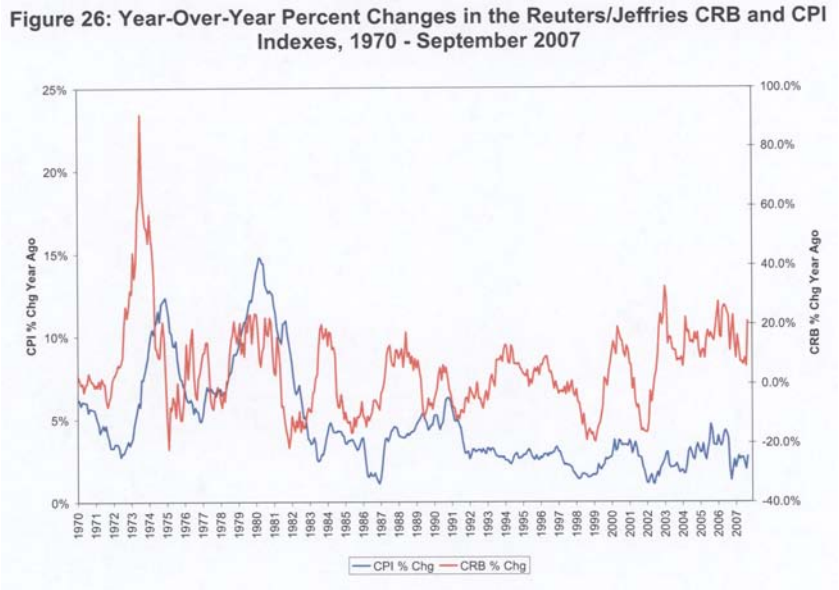
Crude oil, heating oil, and unleaded gasoline carry one-third of the overall weighting of the index. Therefore, it is not surprising that the index has been on a prolonged run as crude oil prices have surged from around $20/barrel in November 2001 to almost $100/barrel in November 2007 (see Figure 24).



However, the weighting of energy commodities in the index masks the fact that the prices of metals and, more recently, agricultural commodities have been increasing. There is some interrelation of the price increases, as the demand for basic materials that has been generated by the strong economic growth in developing countries, especially China and India, encompasses not only energy but also metals. Higher energy prices have been a contributor to higher agricultural commodity prices as well, since they have fostered higher prices for ethanol and biodiesel and the expansion of those industries. Moreover, the depreciation of the U.S. Dollar, which has been particularly acute in the fall of 2007, has affected the prices of multiple commodities, making U.S. corn more affordable and thereby increasing export demand, and contributing to the rise in oil prices (see Figure 25).



In summary, corn has been one of several commodities that have experienced upward price pressure in recent years. Historically, rising prices for commodities in general—not corn in isolation—have contributed to overall macroeconomic inflation (see Figure 26). This was particularly the case during and after the oil price shocks of the 1970s. However, as the U.S. economy has become more service oriented and the manufacturing sector has accounted for a declining share of gross domestic product, there has been less of a direct impact of higher commodity prices on general inflation. Productivity gains have also helped dampen inflation.



IX. CONCLUSIONS

While there have been a number of stories in the media over the last year indicating that consumer food prices are being driven higher by an ethanol-induced increase in corn prices, there is little evidence of such a simplistic cause-and-effect linkage. In reality, a complex set of factors drives the food CPI. In fact, the marketing bill, defined as the portion of the food dollar that is not related to the farm value of raw materials, has a stronger relationship with the food CPI than does the cost of corn. While an increase in corn prices will affect certain industries—for example, causing livestock and poultry feeding margins to be lower than they otherwise would have been—the statistical evidence does not support a conclusion that there is a strict "food-versus-fuel" tradeoff that is automatically driving consumer food prices higher.

APPENDIX A: BACKGROUND ON THE "FOOD VS. FUEL" DEBATE

A. Media coverage

There has been no shortage of media attention given to the food-versus-fuel debate since late 2006. Major news sources such as The Washington Post, Los Angeles Times, CBS News, U.S. News & World Report, and The Wall Street Journal have run stories indicating that rising corn demand is causing an increase in consumer food prices. The following quotes are representative of stories and editorials that have been carried by the media:

—"Corn prices in America have spiked. And since corn is also a prime ingredient for animal feeds and sweeteners, prices likewise are rising for poultry, beef and everything from soft drinks to candy." (The Washington Post; June 30, 2007)

—"While we worry about gas prices, the cost of milk, meat, and fresh produce silently skyrockets. So like the end of cheap energy, is the era of cheap food also finally over?" (Washington Times; June 30, 2007)

—". . . rising food prices are threatening the ability of aid organizations to help the world's hungriest people . . ." (Christian Science Monitor, quoted by CBS News; July 29, 2007)

—"Food prices were up 3.9 percent in April over a year ago. The overall inflation rate in the same period: 2.6 percent. Over the past 5 years, food prices have risen 12.2 percent nationwide. . . . Fuel costs and rising demand for corn are helping to drive the higher prices, experts said. Corn, for instance is in growing demand to make ethanol. Because it's used so much in cattle feed, that's pushing up prices for meat, milk, and eggs." (Chicago Sun Times; June 6, 2007)

—"Ethanol already consumes so much corn that signs of strain on the food supply and prices are rippling across the marketplace." (U.S. News & World Report; February 4, 2007)

—"Further, there's only so much farmland to go around. To meet the Senate's 2022 renewable-fuels mandate of 35 billion gallons using corn would take 96 million acres. Last year, the entire corn crop, most of which went to food, was grown on 80 million acres. The only source of unused farmland is 37 million acres in the Federal Conservation Reserve Program, under which the Government rents cropland from farmers for wetlands and wildlife." (L.A. Times; August 20, 2007)

However, not all mainstream media reports have drawn a simplistic link between ethanol production and food prices. Bad weather, increasing export demand for certain food products, and high transportation costs resulting from rising fuel prices also have been cited as being additional drivers of recent food price increases. Additionally, the declining cost of corn as a proportion of total food prices has been used as a counter-argument, particularly regarding the prices of higher value-added products. Recently, the U.S. Department of Agriculture (USDA) acting Secretary Chuck Conner was noted as saying, "Ethanol fuel is getting too much of the blame for what's happening in grocery store aisles" (Food and Fuel America; October 5, 2007).

While the statements made in the mainstream media are what reach the general public, there is not necessarily much analytic rigor behind them. Given all the claims and counter-arguments in the media, and given the importance of the policy debate occurring regarding renewable fuels, it is useful to look at more in-depth, analytically oriented research on whether there is a connection between ethanol production and consumer food prices.

B. Research publications

Despite the considerable amount of attention given to this topic by the media, relatively few studies have been conducted to provide evidence supporting one side or the other on this issue.

1. Center for Agricultural and Rural Development

A study entitled "Emerging Biofuels: Outlook of Effects on U.S. Grain, Oilseed, and Livestock Markets" (May 2007) was conducted by the Center for Agricultural and Rural Development (CARD) at Iowa State University. This study utilized a multi-product, multi-country, deterministic partial-equilibrium model to evaluate the impacts of ethanol production on planted acreage, crop prices, livestock production and prices, trade, and retail food costs. The analysis assumes current tax credits and trade policies are maintained. Essentially, the study authors customized the modeling system of the Food and Agricultural Policy Research Institute (FAPRI), which models supply and demand for all important temperate-climate agricultural products. This model was then utilized to analyze long-run equilibrium prices under several ethanol outlook scenarios.

The CARD study concluded that ethanol expansion will cause long-run crop, livestock, and retail food price increases. The study predicted that in the long run, general food prices (food at home and food away from home) will increase 0.7 percent to 1.8 percent more than they otherwise would have.

There were two basic ethanol scenarios considered. Under the baseline oil-price assumption, model results indicate a 0.7 percent increase in food prices due to ethanol production. If oil prices were $10/barrel higher than the baseline assumption, the ethanol impact on food prices increases to 1.8 percent. The highest increases are predicted for at-home food prices (0.9 percent-2.2 percent), whereas away-from-home food-price increases are slightly more modest (0.6 percent-1.5 percent).

The study then deconstructs the predicted increase in prices of food consumed at home into more specific food item categories, predicting that the greatest inflationary pressure will be evident in the eggs market. The range in consumer egg price inflation as a result of ethanol production is estimated between 5.4 percent and 13.5 percent. Additional consumer price inflation is estimated to range between 2.5 percent and 6.3 percent for meats, between 1.4 percent and 3.5 percent for dairy, and 0.5 percent to 1.2 percent for cereal and bakery products.

2. National Corn Growers Association/Advanced Economics Solutions

The National Corn Growers Association (NCGA) released a report in March 2007 addressing the impact of higher corn prices on consumer food prices. They compiled the analyses/reports of the USDA, the Bureau of Labor Statistics (BLS), and Advanced Economics Solutions (AES, a consulting firm commissioned by the NCGA to analyze the impact of increased corn prices on retail food prices). Given USDA estimates of food input costs as a percentage of retail food prices and hypothetical corn prices of $3.50 to $4.00 per bushel (bu), AES estimated that retail prices for meat, poultry, fish, and eggs would be 4 percent to 11 percent higher than they otherwise would have been during the 2007–2009 period. As for consumer dairy prices, increases in the range of 4.3 to 8.3 percent were predicted. The study predicts a much lower increase in price inflation levels for cereal/bakery items of 0.67 percent to 1 percent annually. However, an important assumption behind the study is that while food-processing margins might be compressed in the short run due to higher corn prices, in the long run all of the increase in corn prices will be passed on to consumers.

3. U.S. Department of Agriculture

The publication "USDA Agricultural Projections" (February 2007), which was also incorporated into the NCGA report, projected market impacts related to ethanol supply; corn production, prices, and usage; other crop production and prices; livestock production and prices (including the impact of distiller's grains); and farmland values. The study concluded:

—Consumer price inflation rates for red meats, poultry, and eggs will exceed the general inflation rate between 2008 and 2010, raising the inflation rate of food prices (all food) above the general inflation rate by as much as about 0.5 percent;

—Despite this initial period of higher food price inflation, on average, retail food prices will increase less than the general inflation rate over the next 10 years (the food-price inflation rate is predicted to fall below the general inflation rate after 2010); and

—Highly processed foods, such as cereals and bakery products, will rise at a rate near the general inflation rate.[9]

[9] Since the USDA projections were released in February 2007, some of the assumptions are now out of date. For instance, study authors did not foresee 93 million acres planted to corn in 2007, or wheat supply issues that have caused a spike in wheat prices.

4. American Farm Bureau Federation

The American Farm Bureau Federation published an article (July 2007) in which it indicated that while meat and dairy consumer price indices (CPI) have increased more than the "core CPI" (i.e., the average rate of inflation in the general economy, excluding food and energy prices), these increases are not related to corn prices. The analysis illustrates that recent corn price increases are not related to meat and dairy prices (on-farm). The point is made in the article that meat prices were increasing long before corn prices started to increase. It concludes that with little relationship between corn prices and meat and dairy prices, very little of the increase in food costs—particularly for meat and dairy products—can statistically be attributed to increased corn prices.

Senator BROWNBACK. The figure that I've seen is that it reduces the price 15 percent; the gasoline price in the country would be 15 percent higher if not for ethanol. So I think we've got to look at this thing as an overarching supply and demand situation. While you take corn out of the market to make ethanol, it doesn't go in the trash can; it goes in the gas tank; and that there's a supply and demand there that has a positive impact.

Plus, I was looking at the prices. In this country we don't eat that much corn directly. We do some, but mostly it's fed to livestock. So it has an indirect impact on the overall food prices in this country. You can escalate corn prices 40 percent with having minimal, less than 1 percent, impact on overall food prices in the country.

Do you chart that number or look at that number?

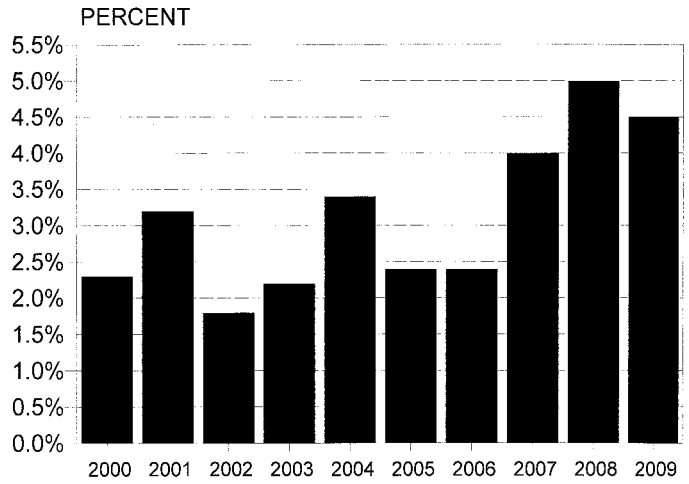
Mr. LUKKEN. Yes, we look at all sorts of fundamental numbers like that, yes.

Senator BROWNBACK. I hope you can supply that one to us as well.

Thank you, Mr. Chairman.

[The information follows:]

CHANGES IN FOOD PRICES FROM PREVIOUS YEAR
2000 THROUGH 2009



SOURCE BLS: 2008 AND 2009 DATA ARE FORECASTS

Senator DURBIN. Chairman Lukken, thank you very much. We appreciate your testimony today. We look forward to sending you some questions in writing, myself and other members of the subcommittee, and hope you can give us some timely answers.

Mr. LUKKEN. Thank you for allowing me to testify.

Senator DURBIN. You bet.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. CHRISTOPHER COX, CHAIRMAN

Senator DURBIN. Chairman Cox, welcome to the subcommittee. Senator Brownback and I are minimizing our opening statements so that we'll have a few more moments to ask questions and not take too much of your own time. If you would like to summarize your opening statement, the entire written statement will be made part of the record.

SUMMARY STATEMENT

Mr. COX. Thank you very much, Mr. Chairman, Senator Brownback, and members of the subcommittee. Thank you for the opportunity to testify today about the President's fiscal year 2009 budget request for the SEC.

I'll begin by saying that, in return for the SEC's not quite $1 billion budget, the taxpaying public is getting significant value. The SEC oversees the nearly $44 trillion in securities trading annually on U.S. equity markets, the disclosures of about 13,000 public companies, and the activities of about 11,000 investment advisers, 1,000 fund complexes, and 5,700 broker-dealers.

The Commission is active on a number of fronts working to protect investors, promote capital formation, and foster healthy markets. The failure of Bear Stearns has brought to the fore the regulatory gap in the supervision of investment banks. Although Federal law provides for supervision of commercial banks, no such scheme exists for the largest investment banks. The Commission created the voluntary Consolidated Supervised Entities (CSE) Program to partly fill this gap. Without this voluntary program, there would have not been any consolidated information available to regulators, including the New York Fed, when Bear Stearns precipitously lost liquidity in mid-March 2008.

While the CSE program is at present voluntary and receives no dedicated funding from the Congress, we understand that Congress may be acting to fill this gap. I strongly support this because of the fact that even today the SEC has no explicit statutory mandate to supervise the Nation's investment banks on a consolidated basis. It is a statutory no-man's-land that should not be tolerated indefinitely.

For the meantime, I have prepared information for the subcommittee concerning the SEC's proposed increases to the staffing in the CSE Program that I have submitted along with my testimony.

In addition to the important work of investment bank supervision, the Congress recently gave the Commission significant new statutory authority over credit rating agencies. That has permitted us to register credit rating agencies with the SEC beginning last fall. As of the end of September 2007, seven credit rating agencies,

including those that are most active in rating subprime securities, became subject to the Commission's new oversight authority.

In the 6½ months since the Commission's authority over these credit rating agencies went into effect, two additional ratings agencies have registered with the Commission, so that now there are nine nationally recognized statistical rating organizations registered with the SEC and in competition in the marketplace.

We have aggressively used our new examination authority under the new law to evaluate whether credit rating agencies are adhering to their published methodologies for determining ratings and managing conflicts of interest. We will shortly publish the findings of these examinations, which have focused on the three largest firms most active in rating subprime-related securities, and we will soon propose significant new rules governing credit rating agencies that build on the lessons learned from the recent subprime market turmoil.

Through the SEC's broader inspection and examination program, the SEC is focusing on securities firms and the adequacy of their controls over valuation, their controls to prevent insider trading, the level of protection they provide to seniors in our markets, and the adequacy of their compliance programs to prevent, detect, and correct violations of the securities laws.

The SEC is also working closely with our fellow regulators to promote the fairness and stability of the markets. Under the recently concluded MOU with the CFTC to which you just referred, Mr. Chairman, and Mr. Chairman Lukken has just talked to you about, we have established what we hope will be a durable process to better regulate today's increasingly interconnected markets.

To better anticipate future problems across all areas of the securities markets, we are more than doubling the size of the SEC's Office of Risk Assessment. The newly expanded office will help throughout the Commission to look around the corners and over the horizon in order to identify potentially dangerous practices before they impact large numbers of investors and the economy as a whole.

From both a budget and a policy standpoint, the SEC is first and foremost a law enforcement agency. The budget submission for fiscal 2009 would represent the largest amount of money ever devoted by the agency to pursuing wrongdoers in all corners of the securities markets. To lever the effectiveness of that investment, we are using new technology, including a new agency-wide enforcement database called the Hub, along with improved management of resources to focus our enforcement efforts on the areas of greatest risk for investors.

The Enforcement Division is aggressively investigating possible fraud, market manipulation, and breaches of fiduciary duty in the subprime area through our subprime working group. It's also pursuing significant investigations of insider trading, wrongdoing in the municipal bond market, Internet and microcap fraud, and scams against seniors. We've taken additional steps to safeguard investors and protect the integrity of the markets by redoubling our efforts to stamp out abusive naked short selling, including recently proposing a rule that would explicitly target naked short selling as fraud.

The SEC is also building upon its growing success in returning funds to harmed investors. Since the agency first received authority from Congress under the Sarbanes-Oxley Act to use FAIR funds, we have returned a total of more than $3.7 billion to harmed investors. We expect to distribute another three-quarters of $1 billion in the next 6 months alone, aided by the establishment of a dedicated Office of Distributions and Collections and a new computer tracking system for investor funds from penalties and other sources called Phoenix.

The SEC's efforts in the international arena have by necessity been a key focus of my chairmanship. The world's regulatory and enforcement authorities are finding that we have to collaborate if we are to protect our own investors. Accordingly, the SEC is working closely with our international counterparts to monitor the markets and pursue fraudsters wherever they run.

We're also exploring the idea of mutual recognition among a very few high standards countries with robust regulatory and enforcement regimes in order to strengthen our level of cooperation.

In recognition of the interconnectedness of global markets, the SEC is continuing to expand our own expertise in international financial reporting standards and to explore additional ways that U.S. investors might benefit from the increased comparability of investments in the marketplace that would result from using a truly global high-quality standard.

This year, after years of experience through the SEC's voluntary interactive data pilot program, the Commission will consider beginning to migrate public company filing with the SEC to interactive data. That would allow investors to have far easier access to information from the paper forms and financial statements that companies have filed since the 1930s. In addition, they would be able to use computers to easily and instantly compare information about the companies and funds in which they invest.

There are other investor-friendly improvements in store for mutual fund disclosure. In the coming months the SEC will consider allowing investors to have access to a summary prospectus for mutual funds that would succinctly present key facts about their funds up front and, with progressively more detailed information available in layers, give them an opportunity to exploit the Internet's easy search capabilities.

PREPARED STATEMENT

Mr. Chairman, these are only some of the highlights of what the agency has recently been focused on and what we have planned for the coming year. The SEC's mandate is as broad as it is important to America's investors and to our markets. On behalf of the agency, let me thank you for the support that you and this subcommittee have so well provided for these vital efforts. I want to thank you for this opportunity to discuss the SEC's appropriation for fiscal 2009, and I look forward to working with you to meet the needs of our Nation's investors. I'll be happy to answer your questions.

[The statement follows:]

PREPARED STATEMENT OF CHRISTOPHER COX

Chairman Durbin, Ranking Member Brownback, and members of the subcommittee: Thank you for the opportunity to testify today about the President's fiscal year 2009 budget request for the Securities and Exchange Commission.

As you know, until this year the Congress had not increased the SEC's budget for 3 years. If the President's budget request for another increase next year is approved, then after years of flat budgets, the SEC will have received a roughly four percent increase over 2 years. After taking inflation and pay increases into account, this budget for fiscal year 2009 would permit the SEC to keep staffing on par with levels in fiscal year 2007—at about 3,470 full-time equivalents.

In return for the SEC's not-quite $1 billion budget, the tax-paying public gets significant value. The SEC oversees the nearly $44 trillion in securities trading annually on U.S. equity markets; the disclosures of almost 13,000 public companies; and the activities of about 11,000 investment advisers, nearly 1,000 fund complexes, and 5,700 broker-dealers. By way of illustration, let me outline some of what the agency achieved during fiscal year 2007.

REVIEW OF FISCAL YEAR 2007

For the SEC's Enforcement Division, which polices the markets and helps keep investors' money safe, fiscal year 2007 was truly a notable year. The Division's results are impressive both in the number of cases filed—the second highest in Commission history—and in their substance, covering a range of topics of critical importance to investors.

Among many highlights, the Commission brought one of the most significant insider trading cases in 20 years. We filed options backdating cases against executives at companies in a range of industries, to stamp out that notorious abuse. Even non-investors benefited from the Commission's efforts: our anti-spam initiative was credited with a 30 percent reduction in the volume of stock market spam emails in an independent industry review. In all, the SEC forced wrongdoers to give up more than $1 billion in illegal profits and pay more than $500 million in financial penalties. In the 17 years since the Congress gave the SEC authority to collect penalties against companies, this is the fifth highest penalties and disgorgement total ever, and $1 billion above the pre-Enron average of the 1990s.

The SEC also continued to aggressively combat scams targeting the retirement savings of America's senior citizens. In fiscal year 2007, the Enforcement Division brought 30 enforcement actions involving investment fraud, abusive sales practices, and other schemes aimed against seniors. In addition, our examination and investor education programs joined with other regulators, law enforcement agencies, the Financial Industry Regulatory Authority, and others to conduct examination sweeps and sponsor events to educate seniors across the country.

The Commission also reached an important new agreement to share enforcement and examination information with the Financial Crimes Enforcement Network (FINCEN), to assist in the identification, deterrence, and interdiction of terrorist financing and money laundering. The agreement will help ensure that SEC-regulated firms have robust anti-money laundering programs and identify financial institutions that are in violation of the Bank Secrecy Act.

The SEC's examination program also worked to identify compliance issues at brokerage firms and investment advisers and correct such problems before they could harm investors. In fiscal year 2007, the SEC conducted more than 2,400 examinations of investment advisers and investment companies, broker-dealers, transfer agents, and self-regulatory organizations. Overall, 75 percent of investment adviser and investment company examinations and almost 82 percent of broker-dealer examinations revealed some type of deficiency or control weakness. Importantly, most examinations resulted in improvements in the firms' compliance programs. Where appropriate, inspection results were referred for enforcement action.

In fiscal year 2007, we also initiated a new program for broker-dealer chief compliance officers that seeks to help them improve their compliance programs, called the CCOutreach BD program. This program has been a great success, involving hundreds of participants.

On the regulatory front, the Commission reformed the implementation of Section 404 of the Sarbanes-Oxley Act, to fulfill the congressional intent that the law's objectives be achieved without waste and inefficiency. These reforms included Commission approval of a new auditing standard to ensure that 404 audits are conducted in a more cost-effective way, and that they focus on areas that truly matter to investors. The Commission also adopted Section 404 guidance for management, who previously had to rely on the rules intended for auditors. Currently, the staff is undertaking a study to determine whether as a result of these reforms Section 404 is in

fact being implemented in a manner that is efficient and that will be cost-effective for smaller reporting companies. The study will be completed before small companies are required to have their first audit under Section 404. In addition, during 2007 the Commission approved a series of reforms to help smaller companies gain faster and easier access to the financial markets when they need it.

One of the most significant disclosure initiatives in the Commission's history was our new comprehensive disclosure regime for executive compensation, which took effect in 2007. These new rules require every public company to provide a single number stating total compensation for their top officers. For the first time, all forms of compensation are in one place for investors to analyze, and companies are required to provide plain English statements of their compensation policies. The complete and readily accessible information about executive pay that this initiative has opened up to investors has provided a valuable new insight into corporate governance in the Nation's public companies.

Also in 2007, the SEC broke an 8-year logjam by publishing final rules to implement the Gramm-Leach-Bliley Act's bank-broker provisions. This will benefit investors who utilize banks as well as brokers to help achieve their financial objectives. And we approved the merger of the NYSE and NASD's regulatory arms, with the goal of creating a single set of rules and eliminating the regulatory gaps between markets that often made enforcement difficult.

The Commission also significantly intensified its contacts with its counterparts across the globe. As Chairman, I executed agreements with the College of Euronext Regulators, the German Federal Financial Supervisory Authority, and the UK's Financial Services Authority and Financial Reporting Council, all aimed towards enhancing information-sharing on enforcement and supervisory matters. The Commission also approved the merger of the New York Stock Exchange and Euronext; streamlined the deregistration requirements for foreign private issuers, removing a significant deterrent to listing on U.S. exchanges; and authorized foreign firms to use IFRS as published by the International Accounting Standards Board in preparing their disclosures in the United States. These important steps have helped facilitate cross-border capital formation and helped our market better integrate with the rest of the world.

Administratively, we undertook major reforms to improve the effectiveness of the SEC's operations. In 2007, the SEC significantly augmented its investor education and advocacy functions. To reinvigorate the agency's emphasis on the needs of retail investors, we created the Office of Policy and Investor Outreach which will assess the views of individual investors and help inform the agency's policymaking. The new Office of Investor Education is focused exclusively on promoting financial literacy and helping investors gain the tools they need to make informed investment decisions.

In 2007, the SEC took major steps to foster the widespread use of interactive data in corporate disclosures. Interactive data will empower investors to obtain and compare information about their investments far more easily than ever before. This initiative will completely remake financial disclosure. Instead of an electronic filing cabinet for 1930s-style forms, which was the SEC's EDGAR system, every item within an income statement or a balance sheet will be individually searchable and downloadable. Investors and the entire marketplace will be able to compare any information they choose for thousands of companies in an instant. RSS feeds will send the latest SEC filings to investors' desktops or handhelds, without their even having to know a form was filed.

Overall in fiscal year 2007, the SEC had one of the most productive years in its history, aggressively pursuing wrongdoing and tackling fundamental reforms in the securities markets, all on behalf of America's investors.

FISCAL YEAR 2008 TO DATE

Already in fiscal year 2008, the Commission has been active on a number of fronts working to protect investors, promote capital formation, and foster healthy markets. And our agenda in the coming months is no less ambitious.

Oversight of the Markets

The failure of Bear Stearns has brought to the fore the regulatory gap in the supervision of investment banks. Although Federal law provides for supervision of commercial banking by bank regulatory agencies, no such scheme exists for the largest investment banks. Because the law fails to provide for supervision of even the largest globally active firms on a consolidated basis, the Commission created the Consolidated Supervised Entities (CSE) program to fill this gap, beginning in 2004. Without this voluntary program there would not have been any consolidated information available to regulators, including the Federal Reserve Bank of New York,

when Bear Stearns precipitously lost liquidity in mid-March 2008. This program, which is necessary to monitor for, and act quickly in response to, any financial or operational weaknesses that might place regulated entities or the broader financial system at risk, is providing the basis for significant new collaboration with the Federal Reserve.

Building on the new statutory authority from Congress that enabled the SEC to register and examine credit rating agencies, as nationally recognized statistical rating organizations, beginning in late September 2007, the SEC has launched a new program to oversee credit rating agencies. This is also a vitally important topic in light of recent market events. Under this new authority, the Commission is conducting inspections of rating agencies to evaluate whether they are adhering to their published methodologies for determining ratings and managing conflicts of interest. Given the recent problems in the subprime market, the SEC has been particularly interested in whether the rating agencies' involvement in bringing mortgage-backed securities to market impaired their ability to be impartial in their ratings. We will shortly propose additional rules building on the lessons learned from the subprime market turmoil. These proposals may include, among other things, requiring better disclosure of past ratings, so as to facilitate competitive comparisons of rating accuracy; enhancing investor understanding of the differences in ratings among different types of securities; regulating and limiting conflicts of interest; reducing reliance on ratings per se, as opposed to the underlying criteria that ratings are thought to represent; and disclosing the role of third-party due diligence in assigning ratings. This will continue to be an area of emphasis for the Commission in the coming fiscal year.

Currently neither the CSE nor the credit rating agency programs receive dedicated funding from the Congress. We understand that Congress may be acting to fill this gap, and I believe such a move would help formalize and strengthen these two critical programs. We have prepared some information about this proposal that I have submitted along with my testimony.

The SEC is also working closely with our fellow regulators to promote the fairness and stability of the markets. Under a recently concluded Memorandum of Understanding with the Commodity Futures Trading Commission, we have established a durable process to better address the regulatory issues that in today's increasingly interconnected markets don't respect regulatory boundaries drawn up decades ago. The agreement that I signed with Acting Chairman Lukken establishes a permanent regulatory liaison between the two agencies, provides for enhanced information sharing, and sets forth several key principles guiding their consideration of novel financial products that may reflect elements of both securities and commodity futures or options.

To anticipate future problems, I announced in February 2008 a program to more than double the size of the SEC's Office of Risk Assessment, created under the leadership of my predecessor, Chairman Bill Donaldson. With additional staff experts and the right surveillance tools, the newly expanded Office will help staff throughout the Commission look around the corners and over the horizon to identify potentially dangerous practices before they impact large numbers of investors and the economy as a whole.

Enforcement

The SEC is continuing to pursue wrongdoers in all corners of the securities markets, while also applying enforcement resources to the areas that pose the greatest risks to investors.

The Enforcement Division's subprime working group is aggressively investigating possible fraud, market manipulation, and breaches of fiduciary duty. Among the issues we are looking at is whether financial firms made proper disclosures about their holdings and their valuations, whether insiders used non-public information to gain from the recent market volatility, and whether naked short sellers illegally manipulated the market.

The Enforcement Division is also investigating insider trading among large institutional traders; wrongdoing in the municipal bond market; Internet and microcap fraud; and scams against seniors.

In fiscal year 2008, the SEC is building upon its growing success in returning funds to harmed investors. Since the agency first received authority under the Sarbanes-Oxley Act of 2002 to use Fair Funds to compensate victims, we have returned a total of more than $3.7 billion to wronged investors. We expect to distribute another $750 million in the next 6 months alone. To further professionalize the agency's execution in this area, I have created the Office of Collections and Distributions, which is led by a Director who reports to the Executive Director and the Chairman. As part of this initiative, the agency has deployed a new computer tracking system,

called Phoenix, which with additional enhancements this year will help to speed the return of investors' money and maintain appropriate internal controls.

Another major productivity enhancement in the Enforcement Division is "The Hub," an agency-wide database that gives all enforcement staff access to the entire inventory of investigations. By giving line staff a window into this deep knowledge base, and permitting senior management to direct the resources of the national enforcement program quickly and effectively when necessary, The Hub is significantly increasing the effectiveness of our enforcement dollars. Additional features being rolled out in the coming months will help Division staff more readily access performance information, coordinate more effectively with our examination staff, and better manage their investigative documents throughout the enforcement lifecycle.

International Enforcement and Regulatory Issues

The SEC's efforts in the international arena, which have markedly increased in recent years, have by necessity been a key focus of my Chairmanship. The time is long past when the SEC, or any financial regulator, can feel safe that by scrutinizing just the activities within its national borders, it can comprehend all the potential dangers ahead. In a world where capital flows freely across borders, problems or issues in one corner of the globe rarely stay there. The world's regulatory and enforcement authorities are finding that we have to collaborate if we hope to protect our own investors. Accordingly, the SEC is working closely with our international counterparts to monitor the markets and pursue fraudsters wherever they may run. We are also exploring the idea of mutual recognition among a very few high-standards countries with robust regulatory and enforcement regimes.

In recognition of the interconnectedness of global markets, the SEC will continue to expand our own expertise in IFRS, and explore additional ways that U.S. investors might benefit from increased comparability using a high-quality international standard. The continued integration of our own domestic accounting standards and IFRS will enhance the quality of both, while improving the reliability, clarity, and comparability of financial disclosure for American investors.

Disclosure

The SEC is committed to making public company disclosure more useful to investors. Under the leadership of the Office of Interactive Disclosure, the SEC is building upon our recent successes in constructing a foundation for the widespread use of interactive data. After years of experience through the SEC's voluntary pilot program, the Commission will consider a rule in 2008 that requires the use of interactive data by reporting companies, as well as other proposals to expand interactive data reporting by mutual funds and other market participants. These efforts will be aimed at giving investors the ability to easily find and compare key data about the companies and funds in which they invest.

There are other investor-friendly improvements in store for mutual fund disclosure. Too many investors today throw away their mutual fund disclosures instead of reading them. Too often, the prospectuses are laden with legalese that makes them nearly impenetrable for the average person. In the coming months, the SEC will consider authorizing mutual funds to issue a summary prospectus that will be more user-friendly for investors. If adopted, the summary document would succinctly present key facts about the fund up front, with more detailed information available for investors on the Internet or in paper upon request. The agency also is preparing help for investors at the time they buy a mutual fund to learn about fees, expenses, and conflicts of interest.

Another important initiative relates to the $2.5 trillion worth of municipal securities currently outstanding, about two-thirds of which is owned either directly or indirectly by retail investors. Despite its size and importance, this market has many fewer protections for investors than exist in the corporate market. For example, investors often find it difficult even to get their hands on the disclosure documents for the municipal securities they own. To address this shortcoming, the Commission is working to authorize the creation of an online computer database, which would give investors in municipal securities electronic access to disclosures filed in connection with their investments. I have also urged our authorizing committees in the House and in the Senate to update the SEC's authority in this area.

Investor Protection

The Commission has very recently taken additional steps to safeguard investors and protect the integrity of the markets during short selling transactions by proposing a rule that would specify that abusive "naked" short selling is a fraud. In a naked short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard 3-day settlement period for trades. As a result, the seller fails to deliver stock to the buyer when delivery

is due. This is known as a "failure to deliver." When sellers intentionally fail to deliver securities to the buyer as part of a scheme to manipulate the price of a security, or possibly to avoid borrowing costs associated with short sales, they should be subject to enforcement action by the Commission for violation of the securities laws.

The Commission is also working to protect Americans' pension fund investments. In March 2008, the Commission issued a special report reminding public pension funds of their responsibilities under the Federal securities laws, and warning them that they assume a greater risk of running afoul of anti-fraud and other provisions if they do not have adequate compliance policies and procedures in place to prevent wrongdoing in their money management functions.

To protect investor privacy and to help prevent and address security breaches at the financial institutions the SEC regulates, the Commission proposed new rules that provide more detailed standards for information security programs. The proposed rules provide more specific requirements for safeguarding information and responding to information security breaches. The Commission also extended these privacy protections to other entities registered with the Commission.

The Commission has also proposed an expedited process to speed up the availability to the investing public of exchange-traded funds (ETFs). ETFs are similar to traditional mutual funds, but issue shares that trade throughout the day on securities exchanges. The proposed rules would eliminate a barrier to entry for new participants in this fast-growing market, while preserving investor protections. The Commission also proposed enhanced disclosure for ETF investors who purchase shares in the secondary markets.

Mr. Chairman, these are only some of the highlights of what the agency has recently been focused on, and what we have planned for the coming year. The SEC's mandate is as broad as it is important to America's investors and our markets. On behalf of the agency, let me thank you for the support that you and this Committee have so well provided for these vital efforts.

CONCLUSION

The budget request for fiscal year 2009 will allow the SEC to continue to aggressively pursue each of these ongoing initiatives on behalf of investors, as well as to address new risk areas as they emerge. As I mentioned, the request will allow the SEC to fully maintain our current program of strong enforcement, examinations and inspections, disclosure review, and regulation.

The request also will cover merit raises for SEC staff, as the agency transitions to a new performance evaluation system. This new five-level rating system has been developed in conjunction with the National Treasury Employees' Union to provide more individualized feedback to staff, based on clear performance criteria. The system has been piloted in our Office of Human Resources, and will next be extended to the agency's senior managers. The rest of the agency's employees are scheduled to transition into the program next year.

I want to thank you for this opportunity to discuss the SEC's appropriation for fiscal year 2009. I look forward to working with you to meet the needs of our Nation's investors, and I would be happy to answer any questions you may have.

STAFFING LEVELS

Senator DURBIN. Thank you very much, Chairman Cox.

Let me try to reconcile budget request with some of the policy statements you've made. If I understand the President's budget request for 2009, it calls for 3,409 permanent staff at the SEC, which would be a reduction anywhere between 94 and 100 employees, and over the last 3 or 4 years you've had about an 11 percent reduction in your enforcement activities. Does that sound about right?

Mr. COX. All the way up to the 11 percent reduction in enforcement activities. We have within our overall budget, which is——

Senator DURBIN. Staffing reduction. I'm sorry, staffing reduction of 11 percent since 2005.

Mr. COX. Yes, we have had budget freezes, as you know, from Congress through continuing resolutions in 2006 and 2007. So holding at the same dollar figure for two fiscal years in a row, combined with the fact that we have a built-in ratchet of about 5 per-

cent just standing steady because of cost-of-living allowances, merit pay, and promotions within the agency and an historically low turnover rate, means that, with two-thirds of the total budget going to personnel, it is impossible to maintain even the same staffing numbers year to year at higher dollar levels.

But what we have done within the overall budget number is to prioritize enforcement and also the Division of Trading and Markets and its market supervisory responsibilities, so that in the last fiscal year we have brought the second highest number of enforcement actions in the agency's 74-year history. Likewise, we have the highest number of respondents in actions in years by quite a wide margin.

OVERSIGHT OF INVESTMENT BANKS

Senator DURBIN. So I want to applaud your efficiencies and what you have achieved. But if you continue to reduce the number of staff that are working in some of these sections, some of these divisions within the SEC, it clearly would have an impact on your future activity. One of the things that you raise is something that I'm concerned about. You mentioned the Bear Stearns situation, in which the head of the Federal Reserve as well as the Secretary of the Treasury decided to step in and to help Bear Stearns through a rough patch.

Without judging the wisdom of that decision, and I think it was necessary personally, it seems to have opened up a new area of concern and responsibility. You talked about the gap in enforcement for investment banks. I don't know what the most current figure is, but I heard at one time that we have opened our discount window to the tune of about $200 billion in borrowing by these investment banks.

The obvious question is, the entities that are borrowing the money now from the Federal taxpayers through the discount window, what kind of oversight and supervision we have of these entities. I think what I heard in your opening statement is the suggestion that the SEC may play a role in that or could or should play a role in that.

Reconcile these two things—reducing the number of staffers in your budget and expanding your responsibilities to include investment banks to make sure that at the end of the day the taxpayers of America don't end up holding the bag as investment banks use the discount window.

Mr. COX. Well, Mr. Chairman, you're absolutely right about the importance of that function of overseeing and supervising investment banks. In addition, I would add to that, the SEC also has been given very recently a significant new function related to subprime issues and that is oversight and regulatory authority over credit rating agencies. Both of these functions are prioritized within the SEC's budget, but something has to give. It has to come from some place.

So, if the SEC's budget were to be frozen on a continued basis, we would run out of potential savings. The largest area of potential savings I have been able to find thus far is the agency's historical function of maintaining a filing and information service that was essentially related to the 1930s-era idea of having paper forms. We

had people walk into the SEC and inspect documents. With the Internet we didn't need that any longer, and so we were able to free up about 100 positions within the agency and put those slots to better use.

But the opportunity to find efficiencies like that is a very steep declining curve.

Senator DURBIN. Historically, the SEC has relied on fees and collections to defer their costs of operation to some extent; is that not the case?

Mr. COX. Well, it is partly true, but in a way that concerns me some days, not entirely true, because, while we do collect a good deal in the way of fees, all of our funds are appropriated.

Senator DURBIN. All of your funds——

Mr. COX. We cannot live off of the fees we collect.

IMPOSITION OF USER FEES

Senator DURBIN. I understand that part. But what I'm driving at is, I'm trying to reconcile the earlier question: Where will you find some future SEC Chairman, where will they find the resources to now keep a close eye on investment banks using the discount window, borrowing from American taxpayers? It seems that there should be, and it may not exist today, some fee collection that would fund that Government responsibility. Has that been proposed by the administration or anyone to your knowledge?

Mr. COX. Well, indeed, were this subcommittee willing to do so, taking the existing stream of fees that the SEC already collects and dedicating it to SEC operations would provide a good deal of consistency to the budget.

Senator DURBIN. But those fees are not collected from investment banks currently, are they?

Mr. COX. No, they are not, and we could, I suppose—I should say, Congress could—fashion a new kind of fee. But in any case, the difference between the fees that the SEC's responsible for collecting and our appropriation is already significant. There's a big delta there.

Senator DURBIN. But it would seem, in fairness, that if this branch of our economy is going to be reviewed, there's oversight, that the cost of that oversight shouldn't be borne by another sector of the economy, collection of fees from some other entity. That doesn't seem to track. At least, I don't know in this detail, but it would seem that collecting a fee from the supervised entity is more reasonable.

Mr. COX. Well, I think at least in the SEC's experience we have subsisted entirely on the basis of appropriated funds, and so there has been no effort with respect to any of the agency's programs to match some form of fee collection with our function.

Senator DURBIN. Thank you.

Senator Brownback.

Senator BROWNBACK. Thank you very much, Mr. Chairman.

SUBPRIME MORTGAGE CRISIS

Welcome, Chairman Cox. I want to look at what led up to the subprime debacle that we've had. You can go back after these cri-

ses are over and look at how did all this occur and you hope to learn lessons from that.

I went and met with my realtors in Kansas and different bankers and they said: Oh, yeah, yeah, we knew this was going on; we weren't making any of the loans, but people were out trolling and originating subprime mortgages to people we had never lent to. I even had one banker say to me: Yes, I originated one of the loans that I would never have made, but then put it into the pool for the subprime fund. And I thought, well, at least he admitted it, I guess, but he would never have made it, but it got into then the securitized overall fund.

I want to enter into the record, Mr. Chairman, an article in the New York Times magazine from April 27, 1996, Thomas Friedman, a New York Times columnist, remarked in the "News Hour with Jim Lehrer" that: "There are two superpowers in the world, the United States and Moody's bond rating service, and it is sometimes unclear which is more powerful."

[The information follows:]

[From The New York Times, April 27, 2008]

TRIPLE-A FAILURE

(By Roger Lowenstein)

The Ratings Game

In 1996, Thomas Friedman, the New York Times columnist, Thomas Friedman, the New York Times columnist, remarked on "The NewsHour With Jim Lehrer" that there were two superpowers in the world—the United States and Moody's bond-rating service—and it was sometimes unclear which was more powerful. Moody's was then a private company that rated corporate bonds, but it was, already, spreading its wings into the exotic business of rating securities backed by pools of residential mortgages.

Obscure and dry-seeming as it was, this business offered a certain magic. The magic consisted of turning risky mortgages into investments that would be suitable for investors who would know nothing about the underlying loans. To get why this is impressive, you have to think about all that determines whether a mortgage is safe. Who owns the property? What is his or her income? Bundle hundreds of mortgages into a single security and the questions multiply; no investor could begin to answer them. But suppose the security had a rating. If it were rated triple-A by a firm like Moody's, then the investor could forget about the underlying mortgages. He wouldn't need to know what properties were in the pool, only that the pool was triple-A—it was just as safe, in theory, as other triple-A securities.

Over the last decade, Moody's and its two principal competitors, Standard & Poor's and Fitch, played this game to perfection—putting what amounted to gold seals on mortgage securities that investors swept up with increasing élan. For the rating agencies, this business was extremely lucrative. Their profits surged, Moody's in particular: it went public, saw its stock increase sixfold and its earnings grow by 900 percent.

By providing the mortgage industry with an entree to Wall Street, the agencies also transformed what had been among the sleepiest corners of finance. No longer did mortgage banks have to wait 10 or 20 or 30 years to get their money back from homeowners. Now they sold their loans into securitized pools and—their capital thus replenished—wrote new loans at a much quicker pace.

Mortgage volume surged; in 2006, it topped $2.5 trillion. Also, many more mortgages were issued to risky subprime borrowers. Almost all of those subprime loans ended up in securitized pools; indeed, the reason banks were willing to issue so many risky loans is that they could fob them off on Wall Street.

But who was evaluating these securities? Who was passing judgment on the quality of the mortgages, on the equity behind them and on myriad other investment considerations? Certainly not the investors. They relied on a credit rating.

Thus the agencies became the de facto watchdog over the mortgage industry. In a practical sense, it was Moody's and Standard & Poor's that set the credit standards that determined which loans Wall Street could repackage and, ultimately,

which borrowers would qualify. Effectively, they did the job that was expected of banks and government regulators. And today, they are a central culprit in the mortgage bust, in which the total loss has been projected at $250 billion and possibly much more.

In the wake of the housing collapse, Congress is exploring why the industry failed and whether it should be revamped (hearings in the Senate Banking Committee were expected to begin April 22). Two key questions are whether the credit agencies—which benefit from a unique series of government charters—enjoy too much official protection and whether their judgment was tainted. Presumably to forestall criticism and possible legislation, Moody's and S.&P. have announced reforms. But they reject the notion that they should have been more vigilant. Instead, they lay the blame on the mortgage holders who turned out to be deadbeats, many of whom lied to obtain their loans.

Arthur Levitt, the former chairman of the Securities and Exchange Commission, charges that "the credit-rating agencies suffer from a conflict of interest—perceived and apparent—that may have distorted their judgment, especially when it came to complex structured financial products." Frank Partnoy, a professor at the University of San Diego School of Law who has written extensively about the credit-rating industry, says that the conflict is a serious problem. Thanks to the industry's close relationship with the banks whose securities it rates, Partnoy says, the agencies have behaved less like gatekeepers than gate openers. Last year, Moody's had to downgrade more than 5,000 mortgage securities—a tacit acknowledgment that the mortgage bubble was abetted by its overly generous ratings. Mortgage securities rated by Standard & Poor's and Fitch have suffered a similar wave of downgrades.

Presto! How 2,393 Subprime Loans Become a High-Grade Investment

The business of assigning a rating to a mortgage security is a complicated affair, and Moody's recently was willing to walk me through an actual mortgage-backed security step by step. I was led down a carpeted hallway to a well-appointed conference room to meet with three specialists in mortgage-backed paper. Moody's was fair-minded in choosing an example; the case they showed me, which they masked with the name "Subprime XYZ," was a pool of 2,393 mortgages with a total face value of $430 million.

Subprime XYZ typified the exuberance of the age. All the mortgages in the pool were subprime—that is, they had been extended to borrowers with checkered credit histories. In an earlier era, such people would have been restricted from borrowing more than 75 percent or so of the value of their homes, but during the great bubble, no such limits applied.

Moody's did not have access to the individual loan files, much less did it communicate with the borrowers or try to verify the information they provided in their loan applications. "We aren't loan officers," Claire Robinson, a 20-year veteran who is in charge of asset-backed finance for Moody's, told me. "Our expertise is as statisticians on an aggregate basis. We want to know, of 1,000 individuals, based on historical performance, what percent will pay their loans?"

The loans in Subprime XYZ were issued in early spring 2006—what would turn out to be the peak of the boom. They were originated by a West Coast company that Moody's identified as a "nonbank lender." Traditionally, people have gotten their mortgages from banks, but in recent years, new types of lenders peddling sexier products grabbed an increasing share of the market. This particular lender took the loans it made to a New York investment bank; the bank designed an investment vehicle and brought the package to Moody's.

Moody's assigned an analyst to evaluate the package, subject to review by a committee. The investment bank provided an enormous spreadsheet chock with data on the borrowers' credit histories and much else that might, at very least, have given Moody's pause. Three-quarters of the borrowers had adjustable-rate mortgages, or ARMs—"teaser" loans on which the interest rate could be raised in short order. Since subprime borrowers cannot afford higher rates, they would need to refinance soon. This is a classic sign of a bubble—lending on the belief, or the hope, that new money will bail out the old.

Moody's learned that almost half of these borrowers—43 percent—did not provide written verification of their incomes. The data also showed that 12 percent of the mortgages were for properties in Southern California, including a half-percent in a single ZIP code, in Riverside. That suggested a risky degree of concentration.

On the plus side, Moody's noted, 94 percent of those borrowers with adjustable-rate loans said their mortgages were for primary residences. "That was a comfort feeling," Robinson said. Historically, people have been slow to abandon their primary homes. When you get into a crunch, she added, "You'll give up your ski chalet first."

Another factor giving Moody's comfort was that all of the ARM loans in the pool were first mortgages (as distinct from, say, home-equity loans). Nearly half of the borrowers, however, took out a simultaneous second loan. Most often, their two loans added up to all of their property's presumed resale value, which meant the borrowers had not a cent of equity.

In the frenetic, deal-happy climate of 2006, the Moody's analyst had only a single day to process the credit data from the bank. The analyst wasn't evaluating the mortgages but, rather, the bonds issued by the investment vehicle created to house them. A so-called special-purpose vehicle—a ghost corporation with no people or furniture and no assets either until the deal was struck—would purchase the mortgages. Thereafter, monthly payments from the homeowners would go to the S.P.V. The S.P.V. would finance itself by selling bonds. The question for Moody's was whether the inflow of mortgage checks would cover the outgoing payments to bondholders. From the investment bank's point of view, the key to the deal was obtaining a triple-A rating—without which the deal wouldn't be profitable. That a vehicle backed by subprime mortgages could borrow at triple-A rates seems like a trick of finance. "People say, 'How can you create triple-A out of B-rated paper?'" notes Arturo Cifuentes, a former Moody's credit analyst who now designs credit instruments. It may seem like a scam, but it's not.

The secret sauce is that the S.P.V. would float 12 classes of bonds, from triple-A to a lowly Ba1. The highest-rated bonds would have first priority on the cash received from mortgage holders until they were fully paid, then the next tier of bonds, then the next and so on. The bonds at the bottom of the pile got the highest interest rate, but if homeowners defaulted, they would absorb the first losses.

It was this segregation of payments that protected the bonds at the top of the structure and enabled Moody's to classify them as triple-A. Imagine a seaside condo beset by flooding: just as the penthouse will not get wet until the lower floors are thoroughly soaked, so the triple-A bonds would not lose a dime unless the lower credits were wiped out.

Structured finance, of which this deal is typical, is both clever and useful; in the housing industry it has greatly expanded the pool of credit. But in extreme conditions, it can fail. The old-fashioned corner banker used his instincts, as well as his pencil, to apportion credit; modern finance is formulaic. However elegant its models, forecasting the behavior of 2,393 mortgage holders is an uncertain business. "Everyone assumed the credit agencies knew what they were doing," says Joseph Mason, a credit expert at Drexel University. "A structural engineer can predict what load a steel support will bear; in financial engineering we can't predict as well."

Mortgage-backed securities like those in Subprime XYZ were not the terminus of the great mortgage machine. They were, in fact, building blocks for even more esoteric vehicles known as collateralized debt obligations, or C.D.O.'s. C.D.O.'s were financed with similar ladders of bonds, from triple-A on down, and the credit-rating agencies' role was just as central. The difference is that XYZ was a first-order derivative—its assets included real mortgages owned by actual homeowners. C.D.O.'s were a step removed—instead of buying mortgages, they bought bonds that were backed by mortgages, like the bonds issued by Subprime XYZ. (It is painful to consider, but there were also third-order instruments, known as C.D.O.'s squared, which bought bonds issued by other C.D.O.'s.)

Miscalculations that were damaging at the level of Subprime XYZ were devastating at the C.D.O. level. Just as bad weather will cause more serious delays to travelers with multiple flights, so, if the underlying mortgage bonds were misrated, the trouble was compounded in the case of the C.D.O.'s that purchased them.

Moody's used statistical models to assess C.D.O.'s; it relied on historical patterns of default. This assumed that the past would remain relevant in an era in which the mortgage industry was morphing into a wildly speculative business. The complexity of C.D.O.'s undermined the process as well. Jamie Dimon, the chief executive of JPMorgan Chase, which recently scooped up the mortally wounded Bear Stearns, says, "There was a large failure of common sense" by rating agencies and also by banks like his. "Very complex securities shouldn't have been rated as if they were easy-to-value bonds."

The Accidental Watchdog

John Moody, a Wall Street analyst and former errand runner, hit on the idea of synthesizing all kinds of credit information into a single rating in 1909, when he published the manual "Moody's Analyses of Railroad Investments." The idea caught on with investors, who subscribed to his service, and by the mid-20s, Moody's faced three competitors: Standard Statistics and Poor's Publishing (which later merged) and Fitch.

Then as now, Moody's graded bonds on a scale with 21 steps, from Aaa to C. (There are small differences in the agencies' nomenclatures, just as a grande latte at Starbucks becomes a "medium" at Peet's. At Moody's, ratings that start with the letter "A" carry minimal to low credit risk; those starting with "B" carry moderate to high risk; and "C" ratings denote bonds in poor standing or actual default.) The ratings are meant to be an estimate of probabilities, not a buy or sell recommendation. For instance, Ba bonds default far more often than triple-As. But Moody's, as it is wont to remind people, is not in the business of advising investors whether to buy Ba's; it merely publishes a rating.

Until the 1970s, its business grew slowly. But several trends coalesced to speed it up. The first was the collapse of Penn Central in 1970—a shattering event that the credit agencies failed to foresee. It so unnerved investors that they began to pay more attention to credit risk.

Government responded. The Securities and Exchange Commission, faced with the question of how to measure the capital of broker-dealers, decided to penalize brokers for holding bonds that were less than investment-grade (the term applies to Moody's 10 top grades). This prompted a question: investment grade according to whom? The S.E.C. opted to create a new category of officially designated rating agencies, and grandfathered the big three—S.&P., Moody's and Fitch. In effect, the government outsourced its regulatory function to three for-profit companies.

Bank regulators issued similar rules for banks. Pension funds, mutual funds, insurance regulators followed. Over the 1980s and 1990s, a latticework of such rules redefined credit markets. Many classes of investors were now forbidden to buy non-investment-grade bonds at all.

Issuers thus were forced to seek credit ratings (or else their bonds would not be marketable). The agencies—realizing they had a hot product and, what's more, a captive market—started charging the very organizations whose bonds they were rating. This was an efficient way to do business, but it put the agencies in a conflicted position. As Partnoy says, rather than selling opinions to investors, the rating agencies were now selling "licenses" to borrowers. Indeed, whether their opinions were accurate no longer mattered so much. Just as a police officer stopping a motorist will want to see his license but not inquire how well he did on his road test, it was the rating—not its accuracy—that mattered to Wall Street.

The case of Enron is illustrative. Throughout the summer and fall of 2001, even though its credit was rapidly deteriorating, the rating agencies kept it at investment grade. This was not unusual; the agencies typically lag behind the news. On Nov. 28, 2001, S.&P. finally dropped Enron's bonds to subinvestment grade. Although its action merely validated the market consensus, it caused the stock to collapse. To investors, S.&P.'s action was a signal that Enron was locked out of credit markets; it had lost its "license" to borrow. Four days later it filed for bankruptcy.

Another trend that spurred the agencies' growth was that more companies began borrowing in bond markets instead of from banks. According to Chris Mahoney, a just-retired Moody's veteran of 22 years, "The agencies went from being obscure and unimportant players to central ones."

A Conflict of Interest?

Nothing sent the agencies into high gear as much as the development of structured finance. As Wall Street bankers designed ever more securitized products—using mortgages, credit-card debt, car loans, corporate debt, every type of paper imaginable—the agencies became truly powerful.

In structured-credit vehicles like Subprime XYZ, the agencies played a much more pivotal role than they had with (conventional) bonds. According to Lewis Ranieri, the Salomon Brothers banker who was a pioneer in mortgage bonds, "The whole creation of mortgage securities was involved with a rating."

What the bankers in these deals are really doing is buying a bunch of I.O.U.'s and repackaging them in a different form. Something has to make the package worth—or seem to be worth—more that the sum of its parts, otherwise there would be no point in packaging such securities, nor would there be any profits from which to pay the bankers' fees.

That something is the rating. Credit markets are not continuous; a bond that qualifies, though only by a hair, as investment grade is worth a lot more than one that just fails. As with a would-be immigrant traveling from Mexico, there is a huge incentive to get over the line.

The challenge to investment banks is to design securities that just meet the rating agencies' tests. Risky mortgages serve their purpose; since the interest rate on them is higher, more money comes into the pool and is available for paying bond interest. But if the mortgages are too risky, Moody's will object. Banks are adroit at working the system, and pools like Subprime XYZ are intentionally designed to

include a layer of Baa bonds, or those just over the border. "Every agency has a model available to bankers that allows them to run the numbers until they get something they like and send it in for a rating," a former Moody's expert in securitization says. In other words, banks were gaming the system; according to Chris Flanagan, the subprime analyst at JPMorgan, "Gaming is the whole thing."

When a bank proposes a rating structure on a pool of debt, the rating agency will insist on a cushion of extra capital, known as an "enhancement." The bank inevitably lobbies for a thin cushion (the thinner the capitalization, the fatter the bank's profits). It's up to the agency to make sure that the cushion is big enough to safeguard the bonds. The process involves extended consultations between the agency and its client. In short, obtaining a rating is a collaborative process.

The evidence on whether rating agencies bend to the bankers' will is mixed. The agencies do not deny that a conflict exists, but they assert that they are keen to the dangers and minimize them. For instance, they do not reward analysts on the basis of whether they approve deals. No smoking gun, no conspiratorial e-mail message, has surfaced to suggest that they are lying. But in structured finance, the agencies face pressures that did not exist when John Moody was rating railroads. On the traditional side of the business, Moody's has thousands of clients (virtually every corporation and municipality that sells bonds). No one of them has much clout. But in structured finance, a handful of banks return again and again, paying much bigger fees. A deal the size of XYZ can bring Moody's $200,000 and more for complicated deals. And the banks pay only if Moody's delivers the desired rating. Tom McGuire, the Jesuit theologian who ran Moody's through the mid-90s, says this arrangement is unhealthy. If Moody's and a client bank don't see eye to eye, the bank can either tweak the numbers or try its luck with a competitor like S.&P., a process known as "ratings shopping."

And it seems to have helped the banks get better ratings. Mason, of Drexel University, compared default rates for corporate bonds rated Baa with those of similarly rated collateralized debt obligations until 2005 (before the bubble burst). Mason found that the C.D.O.'s defaulted eight times as often. One interpretation of the data is that Moody's was far less discerning when the client was a Wall Street securitizer.

After Enron blew up, Congress ordered the S.E.C. to look at the rating industry and possibly reform it. The S.E.C. ducked. Congress looked again in 2006 and enacted a law making it easier for competing agencies to gain official recognition, but didn't change the industry's business model. By then, the mortgage boom was in high gear. From 2002 to 2006, Moody's profits nearly tripled, mostly thanks to the high margins the agencies charged in structured finance. In 2006, Moody's reported net income of $750 million. Raymond W. McDaniel Jr., its chief executive, gloated in the annual report for that year, "I firmly believe that Moody's business stands on the 'right side of history' in terms of the alignment of our role and function with advancements in global capital markets."

Using Weather in Antarctica To Forecast Conditions in Hawaii

Even as McDaniel was crowing, it was clear in some corners of Wall Street that the mortgage market was headed for trouble. The housing industry was cooling off fast. James Kragenbring, a money manager with Advantus Capital Management, complained to the agencies as early as 2005 that their ratings were too generous. A report from the hedge fund of John Paulson proclaimed astonishment at "the mispricing of these securities." He started betting that mortgage debt would crash.

Even Mark Zandi, the very visible economist at Moody's forecasting division (which is separate from the ratings side), was worried about the chilling crosswinds blowing in credit markets. In a report published in May 2006, he noted that consumer borrowing had soared, household debt was at a record and a fifth of such debt was classified as subprime. At the same time, loan officers were loosening underwriting standards and easing rates to offer still more loans. Zandi fretted about the "razor-thin" level of homeowners' equity, the avalanche of teaser mortgages and the $750 billion of mortgages he judged to be at risk. Zandi concluded, "The environment feels increasingly ripe for some type of financial event."

A month after Zandi's report, Moody's rated Subprime XYZ. The analyst on the deal also had concerns. Moody's was aware that mortgage standards had been deteriorating, and it had been demanding more of a cushion in such pools. Nonetheless, its credit-rating model continued to envision rising home values. Largely for that reason, the analyst forecast losses for XYZ at only 4.9 percent of the underlying mortgage pool. Since even the lowest-rated bonds in XYZ would be covered up to a loss level of 7.25 percent, the bonds seemed safe.

XYZ now became the responsibility of a Moody's team that monitors securities and changes the ratings if need be (the analyst moved on to rate a new deal). Al-

most immediately, the team noticed a problem. Usually, people who finance a home stay current on their payments for at least a while. But a sliver of folks in XYZ fell behind within 90 days of signing their papers. After six months, an alarming 6 percent of the mortgages were seriously delinquent. (Historically, it is rare for more than 1 percent of mortgages at that stage to be delinquent.)

Moody's monitors began to make inquiries with the lender and were shocked by what they heard. Some properties lacked sod or landscaping, and keys remained in the mailbox; the buyers had never moved in. The implication was that people had bought homes on spec: as the housing market turned, the buyers walked.

By the spring of 2007, 13 percent of Subprime XYZ was delinquent—and it was worsening by the month. XYZ was hardly atypical; the entire class of 2006 was performing terribly. (The class of 2007 would turn out to be even worse.)

In April 2007, Moody's announced it was revising the model it used to evaluate subprime mortgages. It noted that the model "was first introduced in 2002. Since then, the mortgage market has evolved considerably." This was a rather stunning admission; its model had been based on a world that no longer existed.

Poring over the data, Moody's discovered that the size of people's first mortgages was no longer a good predictor of whether they would default; rather, it was the size of their first and second loans—that is, their total debt—combined. This was rather intuitive; Moody's simply hadn't reckoned on it. Similarly, credit scores, long a mainstay of its analyses, had not proved to be a "strong predictor" of defaults this time. Translation: even people with good credit scores were defaulting. Amy Tobey, leader of the team that monitored XYZ, told me, "It seems there was a shift in mentality; people are treating homes as investment assets." Indeed. And homeowners without equity were making what economists call a rational choice; they were abandoning properties rather than make payments on them. Homeowners' equity had never been as high as believed because appraisals had been inflated.

Over the summer and fall of 2007, Moody's and the other agencies repeatedly tightened their methodology for rating mortgage securities, but it was too late. They had to downgrade tens of billions of dollars of securities. By early this year, when I met with Moody's, an astonishing 27 percent of the mortgage holders in Subprime XYZ were delinquent. Losses on the pool were now estimated at 14 percent to 16 percent—three times the original estimate. Seemingly high-quality bonds rated A3 by Moody's had been downgraded five notches to Ba2, as had the other bonds in the pool aside from its triple-A's.

The pain didn't stop there. Many of the lower-rated bonds issued by XYZ, and by mortgage pools like it, were purchased by C.D.O.'s, the second-order mortgage vehicles, which were eager to buy lower-rated mortgage paper because it paid a higher yield. As the agencies endowed C.D.O. securities with triple-A ratings, demand for them was red hot. Much of it was from global investors who knew nothing about the U.S. mortgage market. In 2006 and 2007, the banks created more than $200 billion of C.D.O.'s backed by lower-rated mortgage paper. Moody's assigned a different team to rate C.D.O.'s. This team knew far less about the underlying mortgages than did the committee that evaluated Subprime XYZ. In fact, Moody's rated C.D.O.'s without knowing which bonds the pool would buy.

A C.D.O. operates like a mutual fund; it can buy or sell mortgage bonds and frequently does so. Thus, the agencies rate pools with assets that are perpetually shifting. They base their ratings on an extensive set of guidelines or covenants that limit the C.D.O. manager's discretion.

Late in 2006, Moody's rated a C.D.O. with $750 million worth of securities. The covenants, which act as a template, restricted the C.D.O. to, at most, an 80 percent exposure to subprime assets, and many other such conditions. "We're structure experts," Yuri Yoshizawa, the head of Moody's' derivative group, explained. "We're not underlying-asset experts." They were checking the math, not the mortgages. But no C.D.O. can be better than its collateral.

Moody's rated three-quarters of this C.D.O.'s bonds triple-A. The ratings were derived using a mathematical construct known as a Monte Carlo simulation—as if each of the underlying bonds would perform like cards drawn at random from a deck of mortgage bonds in the past. There were two problems with this approach. First, the bonds weren't like those in the past; the mortgage market had changed. As Mark Adelson, a former managing director in Moody's structured-finance division, remarks, it was "like observing 100 years of weather in Antarctica to forecast the weather in Hawaii." And second, the bonds weren't random. Moody's had underestimated the extent to which underwriting standards had weakened everywhere. When one mortgage bond failed, the odds were that others would, too.

Moody's estimated that this C.D.O. could potentially incur losses of 2 percent. It has since revised its estimate to 27 percent. The bonds it rated have been decimated, their market value having plunged by half or more. A triple-A layer of bonds

has been downgraded 16 notches, all the way to B. Hundreds of C.D.O.'s have suffered similar fates (most of Wall Street's losses have been on C.D.O.'s). For Moody's and the other rating agencies, it has been an extraordinary rout.

Whom Can We Rely On?

The agencies have blamed the large incidence of fraud, but then they could have demanded verification of the mortgage data or refused to rate securities where the data were not provided. That was, after all, their mandate. This is what they pledge for the future. Moody's, S.&P. and Fitch say that they are tightening procedures—they will demand more data and more verification and will subject their analysts to more outside checks. None of this, however, will remove the conflict of interest in the issuer-pays model. Though some have proposed requiring that agencies with official recognition charge investors, rather than issuers, a more practical reform may be for the government to stop certifying agencies altogether.

Then, if the Fed or other regulators wanted to restrict what sorts of bonds could be owned by banks, or by pension funds or by anyone else in need of protection, they would have to do it themselves—not farm the job out to Moody's. The ratings agencies would still exist, but stripped of their official imprimatur, their ratings would lose a little of their aura, and investors might trust in them a bit less. Moody's itself favors doing away with the official designation, and it, like S.&P., embraces the idea that investors should not "rely" on ratings for buy-and-sell decisions.

This leaves an awkward question, with respect to insanely complex structured securities: What can they rely on? The agencies seem utterly too involved to serve as a neutral arbiter, and the banks are sure to invent new and equally hard-to-assess vehicles in the future. Vickie Tillman, the executive vice president of S.&P., told Congress last fall that in addition to the housing slump, "ahistorical behavorial modes" by homeowners were to blame for the wave of downgrades. She cited S.&P.'s data going back to the 1970s, as if consumers were at fault for not living up to the past. The real problem is that the agencies' mathematical formulas look backward while life is lived forward. That is unlikely to change.

Senator BROWNBACK. It goes through how these rating agencies rated these subprime mortgages with an AAA score. I'm trying to piece all this together in hindsight. So, people are originating these loans that locals would not make because it isn't up to their standards. And when you put them all together, it somehow magically transforms into an AAA-rated bond entity that is cited in this article.

I go back on it, Chris, and ask: What should we be doing differently to keep this from happening again? Obviously, we're in a credit crunch and so we're not going to have a lot of money flowing at the moment. Are there things we should be doing to either oversee or rank the bond raters? Should we provide greater oversight on the mortgage originating entities, to make sure that data is there and that the loan is worthy? I think that this whole system is a series of bad practices, trying to get people into loans that they shouldn't have and then catching them in the net.

What's the lesson learned here?

Mr. COX. Well, first, yes to both of your questions. These are both areas that Congress and regulators should take very serious interest in and make big changes in. We are not the front-line regulators for the mortgage industry, but I feel comfortable as Chairman of the SEC commenting on this because of the big impact that it has had in the securities markets, and focusing on proper oversight of mortgage origination is of vital importance for regulators and for lawmakers.

OVERSIGHT OF CREDIT RATING AGENCIES

With respect to credit rating agencies, the Congress has done a very important and wise thing very recently in the Credit Rating Agency Act, giving the SEC brand new authority to regulate and

oversee credit rating agencies that presently we are exercising vigorously. Up until a few months ago, until the end of September last year, the credit rating agency industry was essentially unregulated. Now that is completely changed. We are in the midst of a very broad investigation of the three largest credit rating agencies that rated most of the subprime-related securities. We will report publicly our findings from that examination very soon. The findings of that examination will also inform our ongoing rule-writing that we expect to complete this year. We expect to propose very, very soon new rules to govern, for example, conflicts of interest in that industry, to prohibit certain practices, to make sure that there is full disclosure of things like due diligence in preparation of these ratings, that there's full understanding and disclosure of the various methodologies, and that there's healthy competition in that industry.

None of this existed before. These are big changes and they are very, very necessary.

FINANCIAL SERVICES REGULATORY STRUCTURE

Senator BROWNBACK. Would you mind commenting on the Secretary's comments about the need for changes due to new business structures? He's saying we need to consolidate several of these agencies and remove blind spots. Just your thoughts on that.

Mr. COX. Modernization of financial services regulation, which is the general topic that was broached by the Treasury blueprint, is I think very high on everybody's agenda, in the Congress, certainly for all of us at the SEC and for other regulatory agencies, but also around the world, and in international fora such as the Financial Stability Forum and IOSCO.

The reason is that our regulatory structure is old. It's got quite a pedigree, a distinguished one, but the major regulatory agencies go back to the first part of the 20th century. Our agency is going to turn 75 years old in just a few months. This is already the 75th anniversary of the 1933 act.

So as markets have changed, as the products that Walt Lukken and the CFTC regulate have morphed in such dramatic ways in the 21st century into competitors for products that the SEC regulates, our system has to take that into account. It's very hard to do that, I understand, because of both constituencies in the marketplace who've become accustomed to the existing regulatory structure, because of difficulties in Congress related to different jurisdictions and different committees, and because of some very difficult substantive choices that would have to be made about which model to pick and how to integrate it.

So it's surpassingly difficult. But I think the topic is the right one to focus on because we have to do a better job of integrating regulatory responsibilities if we're going to keep abreast of what's going on, not only in our own country but in interconnected ways around the world.

Senator BROWNBACK. Thank you, Mr. Chairman.

BROKER-DEALER RULEMAKING

Senator DURBIN. Mr. Chairman, on March 19, 2007, the SEC published a proposed rule on amendments to financial responsibility rules for broker-dealers. In the notice the SEC asked for com-

ments on changes to the rules on net capital, customer protection, books and records, notification rules. I understand that some of these proposed amendments have been sought by the financial services community for a number of years.

Among the changes proposed are reduction in capital charges, haircut for money market mutual funds, and the inclusion of certain money market mutual funds as qualified securities eligible for deposit in the special reserve account.

It's my understanding that the comment period closed last June, and since it will soon be a full year since the comment period on the proposed rule elapsed, what is the current status of this rulemaking?

Mr. COX. Mr. Chairman, we are very interested in this subject. We have taken a fresh look at it in light of all the market turmoil to make sure that this is the right time to be embarking on these kinds of changes. But the comment that we have received has included much favorable comment, and so this is very much on the rulemaking agenda of the Commission at this time.

Senator DURBIN. Since it's been a year, what is the anticipated release date for your final rule?

Mr. COX. We don't have a calendar date right now for further action on this proposal. But I would be happy, Mr. Chairman, to report back to you in real time about what the prognosis for that is.

Senator DURBIN. If you would, please.

Are you soliciting additional comments?

Mr. COX. No, I believe the comment period is closed. Let me check and make sure that's the case.

Yes, that is the case.

Senator DURBIN. Is there a plan to reissue a new proposal or are you going to stick with the original proposal?

Mr. COX. I think that the opportunity to fashion a final rule based not only on the proposal but the questions that were asked and the comments that were received should be sufficient so that it would not be required that we repropose it.

Senator DURBIN. If you'd kind of let me know just in general terms when that might happen.

SECURITIES LITIGATION REFORM

Last August, a group of law professors asked your agency to convene a series of roundtables on the topic of securities litigation reform, and the "Wall Street Journal" reported that the forums would occur early next year, implying this year, 2008. Can you tell me if such roundtables are planned or under way?

Mr. COX. Mr. Chairman, this was a suggestion in chief from academics led by, among others, Professor Langwood at Georgetown. It is one that I think for a variety of reasons many people agree the Commission should act upon. There are a variety of reasons across the ideological spectrum and across the markets that people have interest and concerns with this general topic.

My own interest in this topic and experience with it suggests to me that it is best taken up in a bipartisan way. We have currently a short-handed Commission comprised only of Republican commissioners and so I have wanted to wait before we had any such roundtable, even though of course we could always have a balanced

panel, to make sure we also had a balanced Commission that can give the public confidence that we're handling this very important issue with great care and not in any political way.

DIVESTMENT DISCLOSURES

Senator DURBIN. Last question I have. Two weeks ago the SEC adopted rules requiring a registered investment company disclose when it divests from securities of issuers that the fund determines conduct or have direct investments in certain business operations in Sudan. These rules were mandated under the Sudan Accountability Investment Act signed into law on December 31 of last year.

How will the SEC track these particular divestment disclosures?

Mr. COX. Mr. Chairman, as you know, we acted with great alacrity to do what was required by the statute, and we are energetically going to implement it as well, through the Division of Corporation Finance and our Office of Risk Assessment.

Senator DURBIN. So how would an investor be able to quickly determine that a particular company has made such a disclosure, for example?

Mr. COX. I'm sorry?

Senator DURBIN. How would an individual investor be able to determine that a particular company has made such a disclosure?

Mr. COX. Well, all of these filings will be made public and we have taken some very recent measures to provide for full text search capability of filings that are available on our EDGAR online disclosure system.

Senator DURBIN. Good. Thank you.

Senator Brownback, any further questions?

Senator BROWNBACK. No questions.

Senator DURBIN. Chairman Cox, thanks. We appreciate your coming by. We're glad you're working with the CFTC on a memorandum of understanding and how that you'll continue that cooperative arrangement. I asked when they formed this subcommittee to bring these two agencies under the subcommittee's jurisdiction. There are so many things that you do have in common, at least in terms of the integrity of the marketplace. I hope that that conversation continues outside this room.

Thank you for being here today.

Mr. COX. Thank you very much, Mr. Chairman.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. Any questions for the record will be submitted to those who have testified, in the hopes that there will be prompt replies so we can complete our work.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD C. SHELBY

CRA PROGRAM

Question. Chairman Cox, in your testimony you indicated that the SEC's credit rating agency program's costs are approximately $2.2 million. Would you please discuss how these funds would be allocated within the program? How would having

a dedicated funding source for the program improve the SEC's ability to administer the program?

Answer. The SEC created the credit rating agencies program in September 2007 as a result of the enactment of the Credit Rating Agency Reform Act, to ensure that rating agencies are adhering to their published methodologies for determining ratings and managing conflicts of interest. The Act also provides the Commission with authority to write new regulations in this area and inspect the nationally recognized statistical rating organizations for compliance with applicable rules and policies. The SEC's proposed budget for fiscal year 2009 would increase the number of staff responsible for implementing the Credit Rating Agency Reform Act from 7 to 20 positions for oversight and inspections of credit rating agencies. This would nearly triple the number of staff dedicated to the program. Having dedicated funding would give the credit rating agency program more legislative structure and formality and ensure that the agency's allocation of resources was in line with the intent of Congress.

CSE PROGRAM

Question. Chairman Cox, over the past several months our economy has been plague by a liquidity crisis triggered by poorly underwritten subprime loans and structured finance products. The investment banks the SEC regulates as part of the CSE program were among the most active players in both the subprime and structured finance markets. They structured and underwrote many of the financial instruments now causing so many problems for our economy.

—If the SEC was properly monitoring the CSE firms, why did it fail to raise the alarm about the decline in underwriting and lending standards?

—How much responsibility does the SEC bear for the deterioration of lending and underwriting standards by CSE firms and their subsidiaries?

Answer. The President's Working Group noted in their March report to the President that a principal underlying cause of the turmoil in financial markets was "a breakdown in underwriting standards for subprime mortgages" which then rippled through the system as these substandard mortgages were securitized. However, the SEC has no authority over mortgage underwriting standards. The consolidated supervised entities program does not change this reality. Under the Commission's new authority to supervise credit rating agencies, the Commission has recently proposed new rules designed to increase accountability and competition among credit rating agencies, as their ratings may have played a significant role in the market acceptance of subprime-related securities.

ENFORCEMENT

Question. Chairman Cox, earlier today at a hearing of the Banking Committee, former SEC Chairmen Arthur Levitt stated that the SEC needs substantial increases in its enforcement budget and that it does not have the manpower to properly enforce our securities laws.

—How many personnel are presently employed by the Division of Enforcement, and how has that figured changed over the past 10 years?

Answer. In fiscal year 2008, the Enforcement program has over 1,100 permanent FTE which is more than 30 percent higher than the size of the enforcement program since 1998.

[Dollars in millions]

	Enforcement Program FTE	Enforcement Program Salaries and Benefits Obligations
1998	852	[1]
1999	811	[1]
2000	824	[1]
2001	904	[1]
2002	925	[1]
2003	935	[1]
2004	1,144	$168.8
2005	1,232	195.4
2006	1,157	200.6
2007	1,111	197.8
2008 (Budget)	1,124	210.0

[1] Not available.

Question. Also, how do the number of SEC enforcement actions and the amount disgorgements orders during your tenure compare to the levels seen when Chairmen Levitt was at the Commission?

Answer. In fiscal year 2007, the Commission brought the second highest number of cases in the Commission's history including the largest number of corporate penalties cases ever. The chart below, provides the requested information on the nearly seven full fiscal years of Chairman Levitt's tenure and the two full fiscal years of my tenure.

[Dollars in millions]

	Average Number of Enforcement Actions Per Year	Average Disgorgements and Penalties Ordered Per Year
Arthur Levitt, Chairman, July 1993-Feb. 2001	490	$608
Christopher Cox, Chairman, August 2005-present	615	2,483

Note: Figures for Chairman Levitt are totals for fiscal year 1994-fiscal year 2001. Figures for Chairman Cox are totals for fiscal year 2005-fiscal year 2007.

The following table shows the specific figures for each fiscal year during Chairman Levitt's and my tenures:

[Dollars in millions]

	Enforcement Actions	Disgorgements and Penalties Ordered
Under Chairman Levitt:		
1994	497	$764
1995	486	1,028
1996	453	392
1997	489	263
1998	477	477
1999	525	841
2000	503	488
Under Chairman Cox:		
2006	574	3,365
2007	655	1,601

SUBCOMMITTEE RECESS

Senator DURBIN. This meeting of the subcommittee will stand recessed. Thank you.

[Whereupon, at 4:12 p.m., Wednesday, May 7, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009

WEDNESDAY, MAY 14, 2008

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:35 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin and Brownback.

FEDERAL TRADE COMMISSION

STATEMENT OF HON. WILLIAM E. KOVACIC, CHAIRMAN
ACCOMPANIED BY HON. JON LEIBOWITZ, COMMISSIONER

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. I'm pleased to welcome you to this hearing today before the Financial Services and General Government Appropriations Subcommittee.

I apologize for the late start. We had a rollcall vote on the floor, and Senator Reid was called to a funeral service in Arlington for a fallen soldier from Nevada, and I had to fill in for a few minutes there. I thank Senator Brownback as well for his patience in waiting for my arrival.

Today's hearing focuses on the President's fiscal year 2009 budget request for the Federal Trade Commission (FTC). Testifying before us this afternoon is Chairman William Kovacic and Commissioner Jon Leibowitz.

I welcome my colleagues to the dais and those who will appear in short order.

The FTC, Federal Trade Commission, has two important and related missions: to protect consumers and to preserve competition in the marketplace. These missions really hit home when it comes to American consumers as they face skyrocketing prices at gasoline pumps, struggle with home mortgages they may not be able to pay back, and worry about identity theft and privacy in our increasingly intrusive world. The FTC pursues both of its consumer protection and competition missions by identifying illegal practices, stopping them through law enforcement, and preventing them through consumer and business education. It also adds to the public knowledge and dialogue by conducting research, advocating for consumers, and representing American consumer interests.

I am pleased to see the FTC has a strong record on these missions. The agency has received numerous awards for its consumer education programs. Its implementation of the Do Not Call program has enjoyed success in curbing most unwanted telemarketing calls. There are still some of them getting through we will have to talk about. And last year, the FTC received a clean audit opinion for the 11th straight year in a row. Congratulations. With these and other accomplishments, I think the FTC has much to be proud of.

The President's budget requests $256.2 million for fiscal year 2009, increased $12.3 million, or about 5 percent, over current year funding. This request will provide additional funding for consumer protection, including three additional FTE's dedicated to financial services. I am glad you are looking in this area. We are all too familiar with the fraud and deception in the mortgage industry, so this is certainly a good idea.

This request also would provide additional funding for the FTC's Competition Bureau, including eight additional FTEs. Your role as consumer watchdog for anticompetitive behavior is especially crucial in today's market for gasoline, diesel fuel, and jet fuel.

As you know, based on a letter I recently sent to you, I am very concerned about the spike in fuel prices. Drivers across America are paying higher and higher prices at the pump. Air travelers and consumers are also feeling the heat. Projections suggest the situation could get worse. Yet, somehow these record-breaking prices are coming at a time when the oil industry is reporting record-breaking profits.

This chart points out something that an executive from an airline told me just a couple weeks ago when we talked about the increasing cost of jet fuel and what it was doing to the airline industry across America. He had made a phone call to a chief executive officer (CEO) of the same airline who had his job about 15 to 20 years ago, and this former CEO said, I do not understand how you can even operate with the so-called crack spreads today, crack spread being the difference between the crude oil and the refined product.

That differential used to be in the $1 to $5 range. Now it is in the $40 range. And so as you see the price of a barrel of oil going up—I do not know what it is today. I think yesterday it was $127—you have to know that ultimately the consumer will pay even more because the spread between crude oil and refined product just continues to grow exponentially, making it increasingly difficult to be competitive for all users of refined oil products. That would include families, businesses, farmers, truckers, airlines, transit agencies, and all of the above.

I am happy that you will be here to testify about this and other issues, perhaps commenting on the letter that I sent requesting an inquiry. And before turning it over to you for presentation, I would like to invite my colleague, Senator Brownback, to speak.

STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Thank you, Mr. Chairman, for holding the hearing. I look forward to the presentation that is going to be coming up from our colleagues and to our question and answer session.

I think this is an important hearing on some very substantive issues.

I have worked with the FTC over many years on a number of topics, and I have found the Commission very good to work with. I appreciate their mission. I think it is crucial and a delicately balanced one of protecting consumers from fraud and predatory scams, while at the same time not interfering with legitimate business activities. Protecting consumers from identity theft and credit fraud, enforcing the Do Not Call Registry, and prohibiting the marketing of media violence to children, the Commission has a valuable role in our Government.

To carry out its mission, the FTC must look carefully at the facts to guide its efforts. It cannot rely on anecdotes or speculation. It is a difficult function. It requires objective inquiry, analysis, and deliberation. It is not a function that can be exercised properly by a rush to judgment that is based on a theory or popular opinion.

Mr. Chairman, all of us are very concerned and troubled by the exorbitant prices that consumers are paying at the pump. In my State and across the country, farmers, truck drivers, and all working families are facing painfully high prices to put gas in their cars and trucks and to put food on their tables. I would say, Mr. Chairman, if oil companies have acted in an anticompetitive fashion that has harmed consumers, then throw the book at them. I have no qualms about doing that whatsoever, and it should be done and it should be the function of the Government to do it.

Now, let us make sure that they are not colluding and engaging in anticompetitive activities. We must do that. But let us base those claims on facts and not anecdotes and let us find answers and not excuses. And we must pursue real solutions rather than political gain.

In the same way that we admonish our colleagues not to scapegoat ethanol for rising food prices here in the United States and abroad, we need to examine carefully the data and facts surrounding higher gasoline prices. As you and I know, Mr. Chairman, if it were not for the increased use of ethanol and the blending of gasoline, prices at the pump would be some 29 cents to 40 cents higher per gallon. That may explain in part why crude oil prices have risen faster and further than prices at the pump, and we have a chart that I wanted to show on this.

Since January of this year, crude prices are up 21 percent, while gasoline prices are up 19 percent. Since January 2007, the difference is even more pronounced. Crude prices are up 106 percent while gasoline prices are up 94 percent.

The latest data from the Energy Information Administration (EIA) in March 2008 shows that 71.8 percent of the price of a gallon of gasoline is attributable to the raw crude oil input. In March 2007, crude oil accounted for only 52.3 percent of the cost of a gallon of gasoline. In March 2000, crude oil accounted for 44.6 percent of a gallon of gasoline. And that is on the charts.

Crude oil costs are the unmistakable driving force behind the rise in gasoline prices, and for that we need to look in part at our own body here. We have made choices to refuse to allow drilling off the continental shelf and in Arctic National Wildlife Refuge (ANWR). We have chosen to allow antidevelopment and, I believe,

antigrowth activists to block any attempt to expand our Nation's refining capacity. We need to revisit those decisions just as much as we need to examine the behavior of private enterprises.

It is unfortunate the Government is not called to task for its own role in distorting markets and placing increased costs on consumers. Decisions that our Government has made regarding energy policy have contributed to the higher prices that consumers are now paying. And even though the percentage of retail gasoline prices and taxes represent a decline from 32.1 percent in January 2000 to 12.3 percent in March 2008, the actual amount of the tax has not. In January 2000, taxes accounted for 41.4 cents per gallon. In March 2008, they accounted for 39.9 cents per gallon.

I urge the FTC to use its resources to examine diligently and thoroughly all aspects of this issue. In the past, FTC has determined, except in a few isolated cases, that market forces were responsible for large changes in gasoline prices, not anticompetitive actions by the industry. But if you find those anticompetitive actions, we want to know about it and we want them pursued. Let us not think that we need to change the rules or alter the objectivity of scientific analysis and facts just to get the answer we want.

I want to thank you, Mr. Chairman, for holding this hearing. I look forward to the testimony of the witnesses and a chance to question them.

Senator DURBIN. Thank you, Senator Brownback.

As you can tell, we have a slightly different view of the world, and luckily the Federal Trade Commission is here to be the ultimate arbiter.

We want to thank Chairman Kovacic, who will be allowed to make an opening statement, followed by Commissioner Leibowitz. Mr. Chairman.

SUMMARY STATEMENT OF WILLIAM E. KOVACIC

Mr. KOVACIC. Thank you, Chairman Durbin and Ranking Member Brownback. You could not have put the arbitration position in better hands.

We are delighted to have the opportunity to speak to the budget request and to give you a sense of how we would use the funds that have been sought. To divide the labor today, I would like to talk a bit about the competition mission, and my colleague, Commissioner Leibowitz, will address the consumer protection mission.

I want to talk about several areas that are examples of the respects in which I think this true modern success story in public administration provides an excellent return to consumers for the resources you have entrusted us with. Our basic philosophy in competition policy, I think, truly matches the intuition that motivates both of your comments about what we should be doing. We try to use our resources in areas that are of the greatest concern to consumers, and we have tried to address them by using the varied tools you put at our disposal. You not only made us, nearly a century ago, a law enforcement agency, but you entrusted us with research capabilities to get underneath the surface, to understand more fundamentally what is going on in our industries, and to not simply use the prosecution of lawsuits, but the formulation of rules,

consumer education, and publicity as tools for formulating adjustments that we can control ourselves, but advising you as well about what policies should do.

Let me single out several areas of principal concern to us, the areas, among others, in which we will devote our efforts in the competition area with the proposed budget of $256 million.

First and foremost, energy. I share your view that there is no single field of endeavor for us that is more important to the American public, and we expect to approach it, among other areas, in two ways.

As you know, earlier this month we issued an advance notice of proposed rulemaking to explore approaches for applying the market manipulation authority that this body gave us in December. We anticipate that the rulemaking process will be concluded in this calendar year, and there is nothing that my colleagues and I will devote more effort to see addressed as expeditiously and effectively within our agency.

At the same time, we are deeply concerned with structural changes in this sector that can affect the price at which petroleum products, natural gas, other energy products are delivered to consumers. Within the past 12 months, we challenged a natural gas distribution merger in Pittsburgh, which ultimately resulted in the abandonment of the transaction. We brought a case against a combination of two refiners in the southwestern United States involving Western refining and Giant industries. In this we were unsuccessful in obtaining a preliminary injunction. But both matters are indicative of our willingness in all areas to scrutinize very carefully structural adjustments or proposed changes in the industry that would affect competition in this sector.

The second area that is certainly close behind is health care. Two priorities I want to flag for you. The first is our continuing commitment to monitor and to challenge anticompetitive pay-for-delay settlements. Our prosecution of the *Cephalon* case is the latest in our efforts to ensure that the arrangements that Congress set in place with the Hatch-Waxman Act and the promise of lower prices through the provision of generic drugs to consumers are not lost. And even though we have suffered setbacks in a couple of these matters in the courts of appeals, we will continue to press as effectively as we can for successful judicial resolution of these matters. Cephalon is part of our commitment in that area.

We are here also examining structural changes in the sector. Only recently we filed a challenge to a merger in northern Virginia that involves hospital providers, INOVA and the Prince William County Health Care System, again an indication of our commitment to monitor structural changes in this and other important sectors that would affect the price that consumers pay for healthcare.

In the real estate area, we have brought cases involving what we feel are inappropriate arrangements involving multiple listing services.

In the area of standards setting, we were unsuccessful in our *Rambus* case, but within the past couple of years, our successful challenge to an effort by Unocal to distort the process by which the State of California sets standards for gasoline to be sold in that

State, resulted in a settlement that has yielded, we believe, benefits of at least $500 million a year to consumers.

And the last item I want to mention is the very generous allotment that this subcommittee and the Congress as a whole gave us to pursue international matters. We have extended our efforts to work more effectively with our counterparts abroad to provide technical assistance to new competition systems, China, India, among others, and to pursue effective international cooperation under the framework of the SAFE WEB legislation that Congress also enacted in 2006.

PREPARED STATEMENT

Last, I want to mention that we are undertaking a basic self-assessment. We are looking ahead to our centennial in 2014, and we are going to be asking ourselves, with respect to all areas of our operations, are we the agency that Congress intended us to be, what steps can we take to get there? This will fold well into other areas in which Congress has directed us: to examine ourselves, to identify our possibilities for greatness, and to allow no power persuasion to deter us from that mission.

Thank you.

Senator DURBIN. Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF HON. WILLIAM E. KOVACIC

INTRODUCTION

Chairman Durbin, Ranking Member Brownback, and members of the subcommittee, thank you for inviting us to testify today in support of the Federal Trade Commission's (FTCs) fiscal year 2009 appropriation request and to discuss some of the work we will be doing next year. The Commission looks forward to working with you to further the interests of American consumers.

The FTC, though small, is the one Federal agency with both consumer protection and competition jurisdiction across broad sectors of the economy. It enforces, among a broad range of other laws, Section 5 of the Federal Trade Commission Act, which prohibits business practices that are harmful to consumers because they are anticompetitive, deceptive, or unfair.

The Report attached to this testimony, "The FTC in 2008: A Force for Consumers and Competition" provides a detailed overview of the scope of our work. The FTC has pursued a vigorous and effective law enforcement program in a dynamic marketplace that is increasingly global and characterized by changing technologies. Through the efforts of a dedicated staff, the FTC continues to handle a growing workload. This testimony summarizes the FTC's budget request for fiscal year 2009, and describes some of its major activities. To meet the challenges of our Consumer Protection and Maintaining Competition goals in fiscal year 2009, the FTC requests $256,200,000 and 1,102 FTE. The fiscal year 2009 request represents an increase of $12,336,000 and 18 FTE over the fiscal year 2008 enacted levels.

Looking further into the future our success will require continued efforts to improve the institutional mechanism through which we execute our responsibilities. In the coming months we will undertake a program to identify the way ahead. Our focus will extend beyond the next few years, and we will ask what the Agency should look like when our centennial arrives in 2014, and beyond. This self-assessment will include a combination of internal deliberations and external consultations in the United States and overseas with the community of Government and non-Government bodies that have an interest in competition and consumer protection policy.

CONSUMER PROTECTION MISSION

In the consumer protection area, the Commission is active in a variety of efforts to protect the public from unfair, deceptive, and fraudulent practices in the marketplace, including law enforcement targeting telemarketing fraud, deceptive marketing of health care products, consumer fraud against Hispanics, and business op-

portunity and work-at-home schemes. The Commission also has an active program of consumer and business education and outreach. This testimony highlights seven key priorities for the FTC in fiscal year 2009: financial practices; technology (spyware, spam, and behavioral advertising); Do Not Call; privacy and data security; green claims; food marketing to children; and entertainment industry marketing to children.

Financial Practices

The Commission will continue its important work to protect consumers of financial services, focusing on every stage of the consumer credit life cycle, from the advertising and marketing of financial products to debt collection and debt relief. The Commission is particularly concerned at this time about the rise in mortgage foreclosures and delinquencies in the subprime market and its impact on communities.

In the past decade, the Agency has brought 22 actions focused on the mortgage lending industry, with particular attention to the subprime market, alleging that lenders and servicers have engaged in unfair and deceptive advertising and mortgage servicing practices. Through these cases, the FTC has recovered more than $320 million for consumer redress. In addition, these cases serve as notice to the industry generally not to engage in the practices identified as unfair or deceptive. Most of these mortgage cases are complex and take considerable resources to investigate and prosecute, often requiring considerable litigation, in order to obtain adequate redress for consumers and other remedies. The Commission continues its important work in this area.

The Agency is currently investigating the ads of a dozen companies for improperly promoting mortgage products, such as ads that announce low "teaser" rates without explaining that those rates apply for a short period of time and can increase substantially after the loan's introductory period. Commission staff has reviewed hundreds of mortgage advertisements and sent warning letters to 200 mortgage lenders because their ads did not appear to comply with laws the Commission enforces. Staff is examining these companies' more recent advertisements and, where they are noncompliant, the Commission will follow up by bringing cases.

With the rapid increase in mortgage delinquencies and foreclosures, the FTC has also intensified its efforts to protect consumers from mortgage foreclosure rescue scams. Most of these cases involve allegations of scammers who falsely promise that they can save consumers' homes from foreclosure.[1] Since February of this year, the Commission has announced four cases targeting such foreclosure rescue scams.[2] Commission staff also continues to conduct outreach and to share enforcement resources with State and local authorities through seven regional task forces in cities with high foreclosure rates.

The Commission's actions to protect consumers of financial services extend beyond mortgage lending to a wide range of non-mortgage financial services. Earlier this year, the Commission announced that three payday lenders agreed to settle FTC charges that their advertising violated the Truth in Lending Act by failing to provide interest information required by Federal law. This information helps consumers

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[1] In testimony on February 13, 2008 before the Senate Special Committee on Aging on foreclosure rescue fraud, the Commission set forth a more complete description of the FTC's efforts to address such fraud. The FTC's testimony is available at http://www.ftc.gov/os/testimony/P064814foreclosure.pdf.

[2] *FTC* v. *Safe Harbour Foundation*, No. 08 C 1185 (N.D. Ill. filed Feb. 25, 2008), *available at* http://www.ftc.gov/os/caselist/0823028/index.shtm; *FTC* v. *Mortgage Foreclosure Solutions, Inc.*, No. 8:08 CV–00388 (M.D. Fla. filed Feb. 26, 2008) *available at* http://www.ftc.gov/os/caselist/0823021/index.shtm; *FTC* v. *National Hometeam Solutions, Inc.*, No. 4:08–CV–00067 (E.D. Tex. filed Feb. 26, 2008), *available at* http://www.ftc.gov/os/caselist/0823076/index.shtm. *FTC* v. *Foreclosure Solutions, LLC*, No. 1–08–CV–01075 (N.D. Ohio filed Apr. 28, 2008), *available at* http://www.ftc.gov/os/caselist/0723131/index.shtm. Last month, The Bear Stearns Companies, Inc. ("Bear Stearns") disclosed that FTC staff has notified its mortgage servicing subsidiary, EMC Mortgage Corporation ("EMC"), that the staff believes EMC and its parent Bear Stearns have violated a number of Federal consumer protection statutes in connection with its servicing activities. Bear Stearns further disclosed that FTC staff offered an opportunity to resolve the matter through consent negotiations before seeking approval from the Commission to proceed with the filing of a complaint. According to the disclosure, EMC expects to engage in such discussions with Commission staff. Form 10–K, Bear Stearns Mortgage Funding Trust 2007–AR4 (CIK No. 1393708), at Item 1117 of Reg AB, Legal Proceedings (filed Mar. 31, 2008), *available at* www.sec.gov/Archives/edgar/data/1393708/000105640408001164/0001056404-08-001164.txt. The FTC cannot comment further on this ongoing law enforcement investigation.

compare the costs of these payday loans to other payday loans and to alternative forms of short-term credit.[3] The settlements have been accepted for public comment.

In this economy, consumers with high levels of debt are particularly vulnerable to debt collection abuses, as well as debt negotiation and debt consolidation scams. Last November, the Commission announced its largest civil penalty in a debt collection case $1.375 million.[4] In addition, the Commission has prosecuted more than 60 companies engaged in deceptive debt negotiation, debt consolidation, and credit repair practices. The Commission plans to continue its important work in this area in fiscal year 2009.

Technology (Spyware, Spam, and Behavioral Advertising)

The Commission has been at the forefront of protecting consumers from such technological threats as spam and spyware. The Agency has brought more than 100 spam and spyware cases. Earlier this year, the Agency announced its largest civil penalty in a spam case $2.9 million against a company allegedly using deceptive email to offer "free" gifts that were not, in fact, free.[5]

In addition, the Agency identifies and studies potential consumer protection issues raised by new technologies. For example, last week, the Commission hosted a townhall meeting on mobile marketing, which examined such topics as consumers' ability to control mobile applications; the challenges presented by small screen disclosures; practices targeting children and teens; evolving security threats and solutions; and next-generation products and services.

The Commission also continues to examine behavioral advertising, the practice of collecting information about consumers' online habits in order to deliver targeted advertising.[6] Following a workshop on behavioral advertising last fall, the Commission staff released a set of proposed principles to guide the development of self-regulation in this area and sought comment on these principles.[7] The deadline for comments was April 11; the Agency received numerous detailed and thorough comments, which it is currently reviewing.

Do Not Call

The Commission continues aggressively to implement and enforce the National Do Not Call Registry. The Commission is grateful that Congress made participation in the Do Not Call Registry permanent so that consumers will continue to enjoy its benefits without having to re-register. In November 2007, the Commission announced six new settlements and one new Federal court action against companies that violated the Do Not Call provisions of the Telemarketing Sales Rule. The six settlements resulted in $7.7 million in civil penalties for Do Not Call violations.[8]

Privacy and Data Security

Privacy and data security continue to be high priorities for the Commission. In the past 6 months, the Commission announced six new data security cases,[9] bringing the total number of FTC data security cases to 20. Most recently, the Commission announced cases against TJX and Reed Elsevier, the parent company of Lexis Nexis, alleging that the companies engaged in unfair practices by failing to employ reasonable and appropriate security measures to safeguard sensitive data. The settlements have been accepted for comment, and would require the companies to im-

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[3] CashPro, File No. 072–3203 (Feb. 2008); *American Cash Market, Inc.*, File No. 072–3210 (Feb. 2008); *Anderson Payday Loans*, File No. 072–3212 (Feb. 2008) (*all available at* http://www.ftc.gov/opa/2008/02/amercash.shtm).

[4] *United States* v. *LTD Financial Services, Inc.*, Civ. No. H–07–3741 (S.D. Tex. filed Nov. 5, 2007), *available at* http://www.ftc.gov/os/caselist/0523012/index.shtm.

[5] *United States* v. *Valueclick*, No. CV08-01711 MMM (rzx) (C.D. Cal. filed Mar. 13, 2008), *available at* http://www.ftc.gov/os/caselist/0723111/index.shtm.

[6] *See* http://www.ftc.gov/bcp/workshops/ehavioral/index.shtml.

[7] *See* Press Release, FTC Staff Proposes Online Behavioral Advertising Privacy Principles (Dec. 20, 2007), *available at* http://www.ftc.gov/opa/2007/12/principles.shtm.

[8] *See* Press Release, FTC Announces Law Enforcement Crackdown On Do Not Call Violators, Nov. 7, 2007, *available at* http://www.ftc.gov/opa/2007/11/dncpress.shtm.

[9] *United States* v. *American United Mortgage Company*, No. 07C 7064 (N.D. Ill. filed Dec. 17, 2007), *available at* http://www.ftc.gov/opa/2007/12/aumort.shtm; *Life is good, Inc.*, Docket C–4216 (Apr. 2008), *available at* http://www.ftc.gov/os/caselist/0723046/index.shtm; *In the Matter of Goal Financial, LLC.*, Docket No. C–4216 (Mar. 2008), *available at* http://www.ftc.gov/os/caselist/0723013/index.shtm (settlement accepted for public comment); *United States* v. *Valueclick*, No. CV08–01711 MMM (rzx) (C.D. Cal. filed Mar. 13, 2008), *available at* http://www.ftc.gov/os/caselist/0723111/index.shtm; The TJX Companies, File No. 072–3055 (Mar. 2008), *available at* http://www.ftc.gov/os/caselist/0723055/index.shtm (settlement accepted for public comment); *Reed Elsevier, Inc. and Seisint, Inc.*, File No. 052–3094 (Mar. 2008), *available at* http://www.ftc.gov/os/caselist/0523094/index.shtm (settlement accepted for public comment).

plement comprehensive data security programs and third-party assessments biennially for 20 years.[10]

The FTC has also been active on data security education. It has distributed more than 3 million copies of its consumer education publication "Take Charge: Fighting Back Against ID Theft." The FTC also published a guide for businesses on data security, Protecting Personal Information: A Guide for Business, and launched an interactive, online video tutorial designed to educate businesses using real-life scenarios. The Agency has also begun to hold regional workshops for businesses on how to plan and manage data security. The first workshop took place April 15 in Chicago.

Green Marketing

In response to a virtual explosion of green marketing over the past year, the Commission has accelerated its review of its environmental marketing guidelines, also known as the Green Guides.[11] In November 2007, the FTC published a Federal Register Notice seeking public comment on the Guides. Given the importance of green marketing and the proliferation of new claims, the Commission also announced that it would hold a series of workshops in aid of the Guide review. The Commission hosted the first of these events on January 8, 2008, addressing the marketing of carbon offsets and renewable energy certificates. The second workshop, on green packaging, took place on April 30, 2008, and a third workshop, on green claims related to textiles and building materials, is planned for this July. The Commission will use the information it receives at these workshops to inform its review of the Green Guides, conduct enforcement actions, and educate consumers.

Food Marketing to Children

The Commission continues its efforts to combat childhood obesity. In early August, the Commission issued compulsory process orders to 44 food and beverage companies and quick-service restaurants, asking for information on their expenditures and activities targeted toward children and adolescents. All of the targeted companies have submitted their responses, and staff is analyzing the submissions. Staff will prepare a report, submit it to Congress, and release it publicly this summer. The report will be an important tool for tracking the marketplace's response to childhood obesity and identifying where more action is needed.

Entertainment Marketing to Children

The Commission continues to monitor the marketing of violent entertainment to children and encourage industry self-regulation in this area. Since 2000, the FTC has issued six reports on the marketing of movies, music, and video games containing content that may not be appropriate for children.[12] The Commission's reports generally document improvement by all three industries in providing rating or labeling information in advertising. The Commission has also conducted five "undercover shops," in which underage teenagers try to purchase media rated or labeled as containing inappropriate content. These undercover shops have demonstrated steady improvement in retail enforcement of the age ratings.

Last week, the Commission released the results of its fifth undercover shop. These results show improvement, particularly by the video game industry, which denied sales of Mature-rated games to our underage shoppers 80 percent of the time. This is a dramatic improvement from where the industry started 8 years ago, when nearly 9 out of 10 underage shoppers were able to buy these games. There are, however, still areas for improvement. For example, roughly half of our undercover shoppers were able to purchase R-rated or unrated DVDs and explicit content music. The Commission will continue to monitor self-regulatory efforts in this area.

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[10] The TJX Companies, File No. 072–3055 (Mar. 2008), *available at* http://www.ftc.gov/os/caselist/0723055/index.shtm; In the Matter of *Reed Elsevier, Inc. and Seisint, Inc.*, File No. 052–3094 (Mar. 2008), *available at* http://www.ftc.gov/os/caselist/0523094/index.shtm.

[11] *See* Press Release, FTC Reviews Environmental Marketing Guides, Announces Public Meetings (Nov. 26, 2007), *available at* http://www.ftc.gov/opa/2007/11/enviro.shtm.

[12] Moreover, in 2006, the Commission initiated and settled an action against Take-Two Interactive Software, Inc. and Rockstar Games, Inc., the creators and distributors of the popular Grand Theft Auto: San Andreas video game, because they advertised the Entertainment Software Rating Board ("ESRB") rating for the game but failed to disclose that the game discs contained potentially viewable sexually explicit content that was unrated by the *ESRB. Take-Two Interactive Software, Inc.*, No. C–4162 (July 21, 2006), *available at* http://www.ftc.gov/os/caselist/0523158/0523158.shtm.

COMPETITION MISSION

The Commission has an active enforcement agenda to promote and protect competition, focusing on areas that are highly important to consumers, such as health care, energy, real estate, and high technology and standard setting. The Commission scrutinizes mergers in many industries, filing actions to enjoin those that are likely to be anticompetitive and ordering divestitures where appropriate to preserve competition while allowing the beneficial aspects of the merger to proceed. The Commission also polices anticompetitive conduct, with a particular focus on competitor collaboration and exclusionary conduct. Additionally, the Commission promotes sound competition policy through myriad research and reports, studies, hearings, workshops, advocacy filings, and amicus briefs. The Commission is also very active on the international front, developing strong working relationships with foreign antitrust agencies, cooperating on cross-border cases, promoting convergence on competition policies, and offering technical assistance to countries with relatively new competition laws.

This portion of the testimony highlights several important recent developments in the Commission's competition agenda.

Health Care (Pay-For-Delay Settlements and Hospital Mergers)

In the health care area, the Commission is continuing its efforts to prevent brand name drug companies from paying generic competitors to stay out of the market, thereby depriving consumers and other payers of significant savings. In February 2008, the Commission filed a case charging that Cephalon, a pharmaceutical manufacturer, engaged in illegal conduct to prevent competition for its branded drug, Provigil,[13] by paying four competing firms to refrain from selling generic versions of the drug until 2012.[14] The Commission's complaint alleges that Cephalon's conduct constituted an abuse of monopoly power that is unlawful under Section 5 of the FTC Act. The Commission also has several other exclusion payment ("pay-for-delay settlement") investigations ongoing.

These deals are a growing problem due to two court decisions taking a lenient view of the practice. Between 2000 and 2004, there were no patent settlements in which the generic received compensation and agreed to stay off the market, but after the two court decisions in 2005, there were 3 such agreements in fiscal year 2005 and 14 in fiscal year 2006. The Commission strongly supports legislation to address competitive problems with pay-for-delay settlements. We note that bills have been introduced in both chambers, and thank you, Mr. Chairman, for your sponsorship of the bipartisan Senate bill.[15]

Last week the Commission voted to challenge the Inova Health System's proposed acquisition of the Prince William Health System. The proposed merger would combine Inova, the largest hospital system in Northern Virginia, with the Prince William Hospital in Prince William County, Virginia. The Commission alleges that the merger would eliminate the existing, significant price and non-price competition between these hospitals, particularly in the fast-growing western suburbs of Northern Virginia, leading to higher health care costs for the employers and residents of Northern Virginia.

Energy

The Commission shares the concerns of lawmakers, businesses, and American consumers about rapidly increasing prices for crude oil, gasoline,[16] diesel fuel, jet fuel, and natural gas, and currently engages in a wide range of activities to prevent improper industry conduct causing such price rises. Under new authority to promulgate regulations provided in Section 811 of the Energy Independence and Security Act of 2007 (EISA), this month the Commission issued an Advance Notice of Proposed Rulemaking (ANPR) regarding manipulation of wholesale crude oil, gasoline, or petroleum distillate markets. The ANPR, available on the Commission's website and in the Federal Register, solicits public comments on determining whether and

[13] Provigil is used to treat excessive sleepiness in patients with sleep apnea, narcolepsy, and shift-work sleep disorder.

[14] *FTC* v. *Cephalon, Inc.*, No. 1:08–cv–00244 (D.DC. filed Feb. 13, 2008), *available at* http://www.ftc.gov/os/caselist/0610182/080213complaint.pdf.

[15] Preserve Access to Affordable Generics Act, S. 316, 110th Cong. (2007) (as reported by S. Comm. on the Judiciary).

[16] The Commission actively and continuously monitors retail and wholesale prices of gasoline and diesel fuel, looking for "unusual" price movements and then examining whether any such movements might result from anticompetitive conduct that violates Section 5 of the FTC Act. FTC economists have developed a statistical model for identifying such movements. The Agency's economists regularly scrutinize price movements in 20 wholesale regions and approximately 360 retail areas across the country.

in what ways the Commission should develop a rule defining and prohibiting market manipulation in the petroleum industry.[17] The 30-day public comment period runs through June 6, 2008, and the Commission anticipates concluding the rulemaking process this year. In addition, Section 812 of that act prohibits knowingly reporting false data to a Federal agency under a mandatory reporting requirement, with the intention of affecting the Agency's data compilations for statistical or analytical purposes. The section provides for Commission enforcement with substantial penalties.

To protect and promote competition in the energy industry, the Commission reviews mergers and investigates pricing and other conduct.[18] Over the past several years, the Commission has challenged many mergers in this industry, obtaining significant divestitures to preserve competition.[19]

In the past year, we have acted to block acquisitions in the natural gas and petroleum industries that we believed could raise prices to consumers. In January 2008, Equitable Resources abandoned its proposed acquisition of the Peoples Natural Gas Company, a subsidiary of Dominion Resources, after the Third Circuit took the unusual step of granting the Commission's motion for an injunction pending appeal, and vacated the District Court's ruling dismissing the Commission's complaint.[20] The Commission alleged that parties were each others' sole competitors in the distribution of natural gas to non-residential customers in the Pittsburgh area and the transaction would have resulted in a monopoly for many customers. Moreover, in May 2007, the Commission brought an enforcement action in the oil and gasoline industry when it issued an administrative complaint and initiated a Federal court action to block Western Refining, Inc.'s $1.4 billion proposed acquisition of rival energy company Giant Industries, Inc. The Commission brought the action in an effort to preserve competition in the supply of bulk light petroleum products, including motor gasoline, diesel fuels, and jet fuels, in northern New Mexico. After a week-long trial, the Federal district court denied the Commission's motion for a preliminary injunction.[21] The Commission is continuing to examine and address a wide range of issues in the energy markets.[22]

Real Estate

In another area critical to consumers, the Commission continues to challenge realtor board rules that restrain competition and hinder consumer choice in markets throughout the country. The Commission's cases allege that associations of competing real estate agents have adopted rules that limit competition from non-traditional and discount brokers by restricting these brokers from, in part, placing listings on MLS Internet sites, thus harming consumers who may prefer to list with less expensive or non-traditional brokers. Six of our cases were resolved by consent order requiring each realtor board to discontinue enforcing the policies that, the Commission alleged, kept nontraditional brokers from competing. A seventh investigation led to an administrative complaint against a realtor group, which after a full administrative trial and dismissal of the complaint against the realtors by the ALJ is on appeal before the Commission. Oral arguments were held in April, and

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[17] FTC Seeks Public Comment on Rulemaking to Prohibit Market Manipulation in the Petroleum Industry, Press Release, May 1, 2008, *available at*: http://www.ftc.gov/opa/2008/05/anpr.shtm, 73 Fed. Reg. 25614 (May 7, 2008).

[18] In 2005, the Commission settled an enforcement action charging that Unocal deceived the California Air Resources Board ("CARB") in connection with regulatory proceedings to develop the reformulated gasoline standards that CARB adopted. We believe the settlement continues to result in an estimated $500 million of consumer savings at the pump each year. See the discussion in Section III.D below.

[19] These include Mobil/Exxon, British Petroleum/Amoco, Chevron/Texaco, and Phillips Petroleum/Conoco.

[20] *See FTC* v. *Equitable Resources, Inc.*, No. 07–2499 (3rd Cir. 2008), *available at* http://www.ftc.gov/os/caselist/0610140/080204ftcmovacateequitabledecision.pdf.

[21] The Commission subsequently dismissed its administrative complaint, concluding that further prosecution would not be in the public interest.

[22] For example, in November 2007, the Commission issued its third annual report on the state of ethanol production in the U.S. The report noted that, as of September 2007, 13 firms had entered into the production of ethanol during the preceding year, bringing the total number of U.S. producers to 103. As new firms have entered, the market, which is unconcentrated by any measure of capacity or production, has become even more unconcentrated. 2007 Federal Trade Commission Report of Ethanol Market Concentration (Nov. 2007) *available at* http://www.ftc.gov/reports/ethanol/2007ethanol.pdf.

Additionally, the Commission is preparing its first report for the Committees on Appropriations summarizing the Commission's activities relating to ongoing reviews of mergers, acquisitions, and other transactions in the oil and natural gas industries, the investigation of pricing behavior or any potential anticompetitive actions in those industries, and the resources that the Commission has devoted to such reviews and investigations during the 6-month period.

a Commission opinion is expected in the next months. The Commission also settled an action raising similar concerns with a Milwaukee-based realtor group in the past year.[23]

High Technology and Standard Setting

The Commission continues to remain vigilant against mergers and conduct that would distort competition in the high technology industry. One such enforcement case that the Commission has brought is the case against Rambus. In June 2002, the Commission charged Rambus with unlawfully monopolizing four computer memory technologies that were incorporated into industry standards for dynamic random access memory chips, widely used in personal computers, servers, printers, and cameras. In July 2006, the Commission found that Rambus had illegally acquired monopoly power through exclusionary acts, and issued an order limiting the royalty rates Rambus may collect under its licensing agreements.[24] On April 22, 2008, the D.C. Circuit Court of Appeals set aside the Commission's Order and remanded the case for further proceedings before the Commission. The Commission is reviewing the Court of Appeals opinion and will decide in the next few weeks whether to appeal the decision to the full D.C. Circuit or the Supreme Court.

The Commission has previously addressed the substantial consumer harm, including higher prices, that can result from the alleged abuse of standard-setting processes. In 2003, the Commission successfully challenged Unocal's alleged illegal acquisition of monopoly power in the technology market for producing Phase 2 "summer-time" gasoline a formulation of low- emissions gasoline mandated for sale and use in California for up to 8 months of the year by misrepresenting that certain information was non-proprietary and in the public domain, while at the same time pursuing patents that would enable it to charge substantial royalties if the information was incorporated into California Air Resources Board ("CARB") standards. The complaint alleged that Unocal induced CARB to adopt standards for this gasoline that substantially overlapped with Unocal's patent rights. The Commission's success is estimated to have saved California consumers over $500 million per year at the pump.

Other

The Commission's efforts to maintain competition are not limited to high profile industries. In January 2008, the U.S. Court of Appeals for the Fifth Circuit upheld a Commission order requiring Chicago Bridge & Iron Co., N.V. and its United States subsidiary (CB&I) to divest assets acquired from Pitt-Des Moines, Inc. used in the business of designing, engineering, and building field-erected cryogenic storage tanks.[25] The Commission had ruled in 2005 that CB&I's acquisition of these assets in 2001, would likely result in a substantial lessening of competition or tend to create a monopoly in four markets for industrial storage tanks in the United States. The court endorsed the Commission's findings that the merged firms controlled over 70 percent of the market, and that new entry was unlikely given the high entry barriers and based on the incumbents' reputation and control of skilled crews.

The Commission continues to appeal its case against Whole Foods Market, Inc.'s acquisition of its chief rival, Wild Oats Markets, Inc., on the grounds that the district court failed to apply the proper legal standard that governs preliminary injunction applications by the Commission in Section 7 cases. The Court of Appeals for the District of Columbia Circuit heard oral arguments on this case on April 23, 2008.

NEEDED RESOURCES FOR FISCAL YEAR 2009

To meet the challenges of its Consumer Protection and Maintaining Competition goals in fiscal year 2009, the FTC requests $256,200,000 and 1,102 FTE. The fiscal year 2009 request represents an increase of $12,336,000 and 18 FTE over the fiscal year 2008 enacted levels.

The Commission seeks these additional resources to continue to build on its record of accomplishments in enhancing consumer protection and protecting competition in the United States and, increasingly, abroad. The increase of $12,336,000 that the Commission is seeking in fiscal year 2009 includes:

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[23] Press Release, FTC Charges Milwaukee MLS with Illegally Restraining Competition (Dec. 12, 2007), *available at* http://www.ftc.gov/opa/2007/12/mls.shtm.

[24] Press Release, FTC Issues Final Opinion and Order in Rambus Matter (Feb. 5, 2007), *available at* http://www.ftc.gov/opa/2007/02/070502rambus.htm.

[25] *FTC* v. *Chicago Bridge & Iron Co.*, No. 05–60192 (5th Cir. 2008) *available at* http://www.ftc.gov/os/adjpro/d9300/080125opinion.pdf.http://www.ftc.gov/opa/2008/01/cbi.shtm

—$7,989,000 in mandatory cost increases associated with contract expenses (CPI adjustment) and personnel (salaries and with-in-grade increases);
—$2,847,000 for 18 additional FTE;
—10 FTE for Consumer Protection to protect consumers from unfair and deceptive practices in the financial services marketplace; protect consumers' privacy; improve compliance with FTC orders; pursue foreign-located evidence of fraud perpetrated against U.S. consumers; advocate the adoption of foreign data privacy laws and procedures that are compatible with American law; and provide support for the effective operation of this program; and
—8 FTE for Maintaining Competition to meet the increased workload required to challenge anticompetitive mergers and assure that the marketplace is free from anticompetitive business practices in the health care, pharmaceutical, energy, and technology sectors; promote convergence in competition policy of foreign enforcement practices; and provide support for the effective operation of this program;
—$1,500,000 for non-FTE program needs;
—$1,100,000 for Consumer Protection;
—$500,000 for "Green" marketing research, education campaign, and enforcement;
—$250,000 for high-tech tools to stop fraudsters;
—$250,000 for marketing and advertising of food to children;
—$100,000 for privacy and identity theft and deceptive and unfair practices in mobile marketing; and
—$400,000 for Maintaining Competition to meet the challenges of an increased enforcement agenda and associated litigation and outreach efforts.

The majority of the funding for the FTC's fiscal year 2009 budget request will be derived from offsetting collections; HSR filing fees and Do Not Call fees will provide the Agency with an estimated $189,800,000 in fiscal year 2009. The FTC anticipates that the remaining funding needed for the Agency's operations will be through a direct appropriation of $66,400,000 from the General Fund in the U.S. Treasury. The FTC appreciates the strong support it has received from Congress to serve its critical mission of protecting the American consumer and ensuring competition in the marketplace. With the increased funding made available to the FTC in the fiscal year 2008 appropriation for high priority activities including subprime lending, identity theft, the U.S. SAFE WEB Act, market manipulation of petroleum, maintaining competition, and training and technical assistance for developing nations, the FTC will be able to address critical consumer problems at present and anticipate, adapt, and mitigate the challenges of the future.

CONCLUSION

We appreciate the opportunity to appear before you today to discuss the Commission's work and our fiscal year 2009 budget request, and look forward to continuing to work together.

Senator DURBIN. Commissioner Leibowitz.

SUMMARY STATEMENT OF HON. JON LEIBOWITZ

Mr. LEIBOWITZ. Thank you, Mr. Chairman, Ranking Member Brownback. Let me begin by speaking briefly about the Commission generally before I turn to the FTC's consumer protection efforts.

From my perspective, the Commission's biggest challenge is that we are a small agency—we have fewer than 1,100 full-time equivalents (FTEs)—but we are tasked with a big mission: protecting competition and consumers across broad swaths of the economy. The constant challenge for us is not only to effectively leverage our limited resources—I think we do that quite well—but also to ensure that the quality of our work is not strained by the quantity of demands placed upon us.

In the past few years, Congress has enacted new laws, several very important ones, that the FTC is charged with enforcing: CAN–SPAM, the Fair and Accurate Credit Transactions Act (FACT), the

Children's Online Privacy Protection Act (COPPA), to name just a few.

Put simply, implementing and enforcing these laws takes resources. For that reason, we deeply appreciate your efforts to ensure that we have the budget we need. Speaking for myself, I am enormously grateful for the $3 million your subcommittee authorized last year above the administration's request. That enabled us to hire additional employees to bolster our enforcement efforts, especially in the areas of financial fraud and anticompetitive behavior by pharmaceutical companies, which Chairman Kovacic talked about.

Mr. Chairman, the rest of my remarks will focus on some of our consumer protection priorities. I am going to try to do six priorities in 3 minutes.

First, financial services. Chairman Durbin, you mentioned mortgages, and we currently have multiple investigations underway in the subprime market, including two that the targets themselves have made public: investigations of Bear Stearns, for servicing subprime mortgage loans; and of CompuCredit, a leading provider of subprime credit cards. We also are investigating mortgage brokers whose advertising, for example, touted preposterously low interest rates without disclosing that they would increase substantially after a short introductory period. In the past decade, we have brought 22 actions against the mortgage lending industry and obtained more than $320 million in consumer redress.

Indeed, if you combine all the consumer redress, disgorgement, and fines we collect with our Hart-Scott-Rodino and Do Not Call fees, the agency brings back more money to American consumers than it costs.

Second, Do Not Call. The great American philosopher, Dave Barry, has called the Do Not Call Registry the most popular Government program since the Elvis stamp. It has helped preserve the sanctity of the American dinner hour, and we are grateful that Congress made Do Not Call permanent last year. There are nearly 160 million phone numbers registered on Do Not Call and——

Mr. KOVACIC. How many?

Mr. LEIBOWITZ. 160 million registered, and to date we have brought 36 cases against violators.

Third, technology. The Commission has initiated more than 100 spam and spyware actions, and has helped to substantially reduce the nuisance adware problems that have caused literally billions of unwanted pop-up ads on Americans' computers.

We have also held hearings on emerging technologies and practices such as behavioral marketing; that is, the monitoring of consumers' online behavior to deliver targeted advertising. Commission staff recently issued a set of proposed behavioral advertising principles for public comment designed to push self-regulation in the right direction.

Fourth, privacy and data security. Safeguarding consumers' sensitive personal information remains a priority for us. To date, the FTC has brought 20 enforcement actions challenging data breaches and inadequate data security practices.

Fifth, so-called green claims. In the past year or two, there has been an explosion of environmental advertising claims like "sus-

tainable", "renewable", and "carbon neutral". In response, we are holding a series of workshops and updating our environmental marketing guidelines, better known as the Green Guides.

Sixth and finally, an issue I know both of you are interested in, marketing to children. The Commission continues its efforts to combat childhood obesity and foster appropriate food marketing to kids. Last August, the Commission subpoenaed 44 food and beverage companies seeking information on their activities targeted to children. Staff is preparing a report based on what we have learned, and we expect to release it this summer.

The Commission also continues to monitor entertainment industry marketing practices. Since 2000, the FTC has issued six reports on the marketing of movies, music, and video games containing violent content. And last week we released the results of our fifth undercover shopping survey in which underage teenagers tried to buy media labeled as containing inappropriate content. These reports and surveys generally show industry improvement, although further progress would be helpful, especially in the growing marketing of unrated DVDs. Our efforts are designed to encourage further self-regulation in this area. We believe they have been helpful.

With that, I will exercise some self-regulation of my own and stop talking. And I am happy to answer questions.

Senator DURBIN. Thank you, and I think we will have a few.

TRENDS IN THE OIL MARKET

Chairman Kovacic, I wrote you a letter on April 23 urging the FTC to investigate trends in the oil market. We have seen a sudden widening of the difference between crude oil and certain refined petroleum product prices, the so-called crack spread. This crack spread for middle distillate fuels like diesel, home heating oil, and jet fuel has spiked recently, leading to two trends I wrote you about.

First, while gasoline has typically been more expensive than diesel fuel, we have recently seen that trend dramatically reversed. The national average for retail gas, $3.72; the average for diesel fuel, $4.33 a gallon, a difference of 61 cents.

Second, we are seeing a spike in jet fuel costs having a major impact on struggling airlines. Yesterday CNN quoted the CEO of a consumer airline ticket web site as expecting "at least two more price increases before the end of May."

These trends are not linked to changes in crude oil prices or taxes. The crude feedstock for diesel and gasoline is identical, about $3 a gallon, and Federal gas and diesel taxes have not changed for almost 15 years.

I would like to just make a comment. First, I do not think these charts are inconsistent. What Senator Brownback has shown us is that as crude oil prices have gone up, so too has the cost of the refined product, in this case I believe gasoline. I do not quarrel with that.

But this one tells you that the difference between the two is much wider than it once was, and that difference is the refining add-on cost to the basic crude product. And within that add-on cost for refining, the so-called crack spread, turns out to be a world of profit for the oil companies now registering and reporting not only

record oil company profits, but record profits for American businesses. No one has ever been quite this successful in our capital system.

So the question I have is this. Has the FTC been monitoring these trends? Do you plan to initiate a comprehensive investigation or inquiry? And what is driving this?

Mr. KOVACIC. Thank you, indeed, for your letter, Chairman Durbin.

For about the past 3 or 4 years, we have had a program in place to monitor on a retail and wholesale basis price changes concerning gasoline and diesel. The program has not covered jet fuel as well. But we have been examining anomalies as they appear in the pricing and distribution of these products. With your letter in hand, we are expanding our examination of these issues and we are taking a look very closely at both trends in diesel and jet fuel.

I do not have specific results to report to you at the moment, although I do make the offer to meet with you and with my staff as we do learn more from the results of this examination, and I make myself, along with my staff, available to discuss this with you.

What we are seeing in part is that this is an international pattern. That is, from our quick examination to date, these are trends that characterize practice in global markets, Singapore, Europe.

We are also noticing that one notable feature has been a dramatic increase in demand for diesel in recent years. That is, in Europe, in Asia, in a number of areas where we have been able to examine very closely and compare with our own experience, there has been a significant increase in the demand for diesel. We see that as one factor that has probably made the two lines cross that you were referring to before.

Another relationship we are looking at quite carefully is that in the stratum of the refining process, the barrel that is being produced—there is a very close interaction between production capacity and the production of both jet fuel and diesel, kerosene and diesel together. We are looking very carefully at how adjustments in production process and capacity allocation decisions have affected that.

But let me emphasize that your inquiry and others that we have received from your colleagues in this body and across the Capitol—we are looking at this very carefully. I make myself at your disposal to report to you on what we see as the consequence of this deeper look at both diesel and jet fuel.

Senator DURBIN. Thank you. I am glad that the FTC is going to initiate this inquiry, and I am sure it will expand even beyond the questions that I have asked. I hope that it will include questions about refinery capacity and unused capacity. I find it hard to imagine why we are still dealing with about 85 percent use of refinery capacity in a country where the prices are so high.

Second, I hope you will at least explore the question as to whether and, if so, how much the United States is exporting in terms of refined product or even crude product for that matter. There have been calls for us to drill in the Arctic National Wildlife Refuge and other places offshore that are controversial from an environmental viewpoint, and I certainly hope that before we would even consider such a thing, that we would look at other alternatives that would

spare these areas from creating any kind of environmental hardship.

Let me turn it over to my colleague and I will return with some more questions.

Senator BROWNBACK. Thank you, Mr. Chairman.

Examining the data, I think we are using similar charts. It looks like the crack spread has flipped between 2007 to 2008. I have somebody who understands and analyzes this more, but if you look at what has happened on the spot oil price, this chart goes from 2001 to 2008. Yours goes from 2002 to 2007. There has been substantial movement. But I would just point out over a longer period of time, these two track together and you are going to see an increase in gasoline prices.

If there has been market manipulation, I want us to absolutely go after people with hammer and tong on it so that we can get at the bottom of this.

I understand the FTC has recently announced an advance notice of proposed rulemaking on market manipulation of oil and gas prices. How do you see this rule helping the American consumer? What are you targeting? And I know you cannot talk on some of the specifics of this from our previous discussion, but can you give us any thought of what the American consumer can see out of the FTC as a result of this?

Mr. KOVACIC. What I am going to do, Senator, is to give you a snapshot of what was in that notice as an indication of what we will be looking at and, as you mentioned, to be enormously cautious in offering any specific views about what we might do to avoid a possibility of prejudgment.

We intend to examine very carefully a variety of scenarios that are laid out in the advance notice. Among the scenarios for which we have sought comment involves the possibility that there has been fraud with respect to the reporting of information to public authorities, or fraud or misrepresentation with respect to the reporting of information to private bodies that collect and report information on pricing and transactions.

We intend to look very carefully at a collection of scenarios that are closely related to those that our other Federal agencies, the Federal Communication Commission (FCC), Federal Energy Regulatory Commission (FERC), and Commodity Futures Trading Commission (CFTC) have examined in the course of applying manipulation authority. Have there been deliberate efforts in specific instances to exploit shortage conditions as an opportunity to raise prices? Have there been traditional forms of manipulation that would fit within a conventional antitrust or competition context, that is, including the possibility of collusion, improper behavior to exclude other firms?

As laid out in the notice, this range of possibilities, some of them familiar to the concepts that you were alluding to before, Senator, involving outright collusion, traditional antitrust actionable behavior, but not antitrust behavior in many instances examined by our fellow Federal agencies in different settings. Those are the scenarios in the notice that we have asked others to comment upon, and we do welcome the comments before the comment period closes in early June.

Mr. LEIBOWITZ. Yes. And let me just echo what the Chairman has said. We put out, I think, a 38-page advance notice of proposed rulemaking. I think that is the right approach to take because, after all, we have a lot of experience with antitrust, but we do not have a lot of experience with manipulation beyond the antitrust laws.

And in the ANPR—and again, I do not want to talk in too much detail because we do not want to be accused of prejudging; we do not want to be asked to be recused—we show other examples, examples that we want commented on, like very public announcements or pre-announcements of refinery shutdowns, or moving product away from an area where there is a shortage to drive up prices. And so those are the things we want comments on, and we are committed to, I think, completing—we certainly anticipate completing the rulemaking process by the end of the year.

Senator BROWNBACK. Good. I think that is good and I think it is going to be very useful to be able to see that kind of information. As you may know from last week's hearing, we had the CFTC here, and we were talking about market manipulation by large hedge funds, index funds on commodity prices overall. And I think there is more to be looked at there.

FOOD MARKETING TO CHILDREN

On another area, Senator Harkin and I have been working closely together over the last year examining the effects of food marketing to kids. I am very interested in the comprehensive analysis the FTC has undertaken on the types and amounts of food marketing directed at children. It is my understanding the report is due to be released this summer. You have worked on these topics. I have worked with you on these topics before, as you mentioned, Mr. Leibowitz, and on target marketing of violent entertainment to children.

What kind of information should we expect to see in this report that you are going to be putting out on target marketing of food to children?

Mr. KOVACIC. Jon?

Mr. LEIBOWITZ. Well, we hope to complete our report this summer. We did a workshop on this issue. We sent out a number of subpoenas to the major fast food restaurants and food companies.

Maybe we can come in and brief your staff about this. But we are trying to figure out exactly how the targeting is being done and what effect it may have on children. And as you know, because I know you are involved in the FCC task force, childhood obesity has gone up dramatically in the last generation. What used to be called adult-onset diabetes cannot be called that anymore because so many children have it. We think part of that may be due to the foods that they are eating, and so we are taking a look at this marketing and we hope to have something useful to say in the report in the next couple of months. But we will come in and talk to you about it beforehand.

Mr. KOVACIC. I think, Senator, what you certainly can expect to see is what probably will be the best empirical view that a public agency has had to date about some of the phenomena that are being addressed. We are undertaking a very careful effort to gather

data company by company to give you and the larger public a clear view of the advertising trends at issue. This study will be based, again related to a point that both of you made before, as much as possible, on a carefully developed empirical foundation and not simply on hunches.

Senator BROWNBACK. Thank you.

SPECULATION IN THE OIL MARKET

Senator DURBIN. Chairman Kovacic, last week the Wall Street Journal's Market Watch quoted an industry analyst as estimating that about $25 to $30 of price per barrel of crude oil may be attributed solely to speculation. Have you looked into how the futures market is influencing the price of gasoline or other energy products? And if so, what steps do you think should be taken to protect consumers from any excessive speculation?

Mr. KOVACIC. To this point, we have not examined that in a detailed way, Mr. Chairman. What we have seen from our work in the past, looking at the links between futures trading activity and current prices, is that efforts on the part of individual investors to anticipate future developments and make investments unmistakably play some role in setting current prices. What we are not certain of is how much. That is, is it, in the case of the individual quoted in the article, $25 or $30 a barrel? Is it $5 or $10 a barrel? Is it $1 a barrel? That is something we do not know.

I would anticipate pursuing two avenues on this issue. One is in the course of the rulemaking process; one possible avenue identified in the advance notice is to devote closer attention as part of the authority. That is, one possible application of our authority might be to examine these issues in much closer detail.

A second one that I detect in your questioning of Walt Lukken from the CFTC and to some extent with Chris Cox is a concern that whatever we do, we make the best possible use of knowledge that already resides in other public authorities that have been examining this. So in addition to our consultation with them as part of the rulemaking process, we are separately going to work as carefully as possible with the CFTC, with the SEC, and indeed, with FERC, though they do not deal with petroleum prices as such, to see the extent to which we can explore these issues together and to make sure that as our own research program is formulated and, as an enforcement program is developed, that we take the fullest possible advantage of what they have learned. I have met with Chairman Lukken on this point. I have met with Chairman Kelleher, and I anticipate meeting with Chairman Cox as well to ensure that whatever we do builds on the foundation they have already constructed.

Senator DURBIN. It is no secret that Chicago, which I represent, is very interested in the futures markets.

Mr. KOVACIC. There are futures markets in Chicago, yes.

Senator DURBIN. So I am trying my best to look at this in an honest fashion, and when I ask the industry, they say do not forget we are one player, and there are other markets that people can choose to use outside of the United States. And if we take action in the hopes of having impact on speculation, it may just drive the

futures activities to other countries. I assume that will be taken into consideration?

Mr. KOVACIC. Indeed. As a consequence of the augmentation of resources that you provided us last year for international matters, we have a much better platform today than we did 2 years ago to work with our foreign counterparts. I suspect it would surprise neither of you that the issue of energy prices, both with respect to current prices and futures markets, is an acute matter of concern to our counterparts at the Office of Fair Trading in London, to our counterparts in the Bundeskartellamt in Bonn, to our counterparts at the ACCC in Canberra, and to Canada's Competition Bureau in Ottawa. There is no issue, I would suspect, that is more important or compelling to all of us.

And we do have increasingly effective means to cooperate with each other. So the international dimension of this problem will be a crucial element of what we do. Again, by way of thanking you for looking over the horizon to think of the kinds of resources that provide a better basis for us for doing that work and taking that into account, we are in a much better position to do that now than we were previously.

Mr. LEIBOWITZ. Yes. And if I can just add, I agree with everything that the Chairman just said, and we are also going to be reaching out in the rulemaking process to buyers, to customers, and to consumer groups because we really need to learn about this area as we go forward with our manipulation authority.

DO NOT CALL

Senator DURBIN. Commissioner Leibowitz, you mentioned the Do Not Call Registry that Dave Barry had just kind things to say in reference to. And it is my understanding that there are now some 145 million active telephone number registrations in our country, maybe even higher.

Mr. LEIBOWITZ. It is up to 160 million now. It grows every day.

Senator DURBIN. I also understand the FTC has received over 1.2 million consumer complaints alleging violations of the registry. How are you responding? What remedies or relief do you have available when you find violations?

Mr. LEIBOWITZ. Well, that is a really good question. We do collect complaints and that is how we prioritize, in a large way, the law enforcement actions that we take. We have actually brought 36 cases against violators thus far. I think last year, we recovered $7.7 million in fines.

We are fortunate that when we have violations of Do Not Call, we are able to fine malefactors. For most violations of the FTC Act, however, we do not have fining authority. That is an issue that is being discussed in the context of the reauthorization that is going through the Commerce Committee.

But we take Do Not Call very, very seriously. We think it is a wonderful program and an unequivocally successful one, and we spend a lot of resources to make sure that we go after people who are in violation of it.

Senator DURBIN. Thank you.

Senator Brownback.

MARKETING ADULT-RATED ENTERTAINMENT TO CHILDREN

Senator BROWNBACK. Gentlemen, I want to look at the FTC study that previously done on target marketing of adult-rated entertainment material for children. I appreciate you handing me your FTC press release about undercover shoppers finding it more difficult to buy "M" rated games.

You may recall some of the ground-breaking studies and work that were done as the Commerce Committee was pushing on this issue. Mr. Leibowitz, you were working with Herb Kohl. I have worked on it with Senator Lieberman. John McCain was chairing the Commerce Committee when we moved into this area.

Are you looking still at the target marketing of the adult material? This is on the ability to purchase, but not the target marketing of this.

I want to suggest that what you studied in the target marketing of entertainment to underage consumers may be the way you want to study the comparable target marketing of material in the food consumption area. Are you updating the target marketing survey on the entertainment material?

Mr. LEIBOWITZ. Yes. We will be doing another report. We have done six in the last 8 years, I believe, and so we will be doing another entertainment industry marketing report probably sometime toward the end of this year or next year.

And we do look at targeted marketing. In the context of our food marketing to children report, we will be looking at, for example, Internet advertising to kids and the propriety of it and the types of advertising we are seeing. I think in our last report on entertainment industry marketing, we saw that ratings were not as well associated with Internet advertising as they were with, for example, print advertising.

Senator BROWNBACK. I think this is a key area for us. You have correctly identified that we are all seeing this huge onslaught on obesity, particularly in children. We are looking at a possibility of a generation that may not live as long as their parents did and this would be a first for this country, a lot of the problem is just based upon a lack of healthy eating habits.

We are seeing target marketing taking place here, which we saw in the entertainment industry. You guys doing that survey and putting the information out was something that was very helpful to the Congress, and I think it would be very helpful to the country to expose the problem of target marketing of food to children, if it is what is taking place here. This is why it is so hard for mom or dad to go for the Healthy Choice when they are taking the kids to the grocery store or to the fast food restaurant. And the kids say no, as they pull back the other way. We can try to help the parents in that situation. I think it would be very beneficial.

Might I make a suggestion to both of you? I have recently met with the head of the National Institute of Mental Health. The understanding of how the mind works is getting much better. Now, we are a long ways from understanding the most complex physical entity in the entire cosmos. It is the human mind. And then there is a subset of that, the child's mind, even maybe more difficult to understand.

Mr. LEIBOWITZ. And I have two young children, so I know exactly what you are talking about.

Senator BROWNBACK. And it is not fully developed until—I think they are saying now—the age of 23 on average.

But I found it very interesting what we do know. By meeting with them, I might suggest that you bring out some of the experts from the National Institute of Mental Health or you yourself go there and have them tell you what do we know and what do we not know because I think you will find it interesting to your own perspective about regulating advertising or looking at advertising. To ask the question of what is really happenning within this mind, and what do we know and what do we not know, what are we unlikely to know. I think it would be advantageous.

One quick final comment. I hope when you do the gasoline study, which I think can be very helpful, you will look at overall supply and demand situations globally and the effects of transportation because in any sort of global commodity business is effected by supply and demand. The big differential is transportation cost of that commodity. While we may have disputes about domestic production of oil, it does have a significant impact and a more pronounced impact domestically. And I hope you would look into this.

I do not want anything left off the table on this as we look at this very key area and an area of deep concern to us and to the country. I think you guys can provide some overall data to use in this tough time of increasing energy costs.

Mr. KOVACIC. Senator, your comment about the consultation with the authorities at the National Institute of Mental Health fits very well into an approach that we have taken to heart on consultations with others. Indeed, one line of research that we have been spending more time on is the larger question about how people absorb information, what do they understand, adults and children, from the downpour of information that swamps each of us every day. When they see a mandated disclosure, what do they take away from it? We had a very good workshop on what is called behavioral economics, which really goes to this question in many ways, of how people understand images or messages that are being brought to them. So that fits very well—your thought about how to approach that—with other things we are doing, and I will certainly bring that back to my colleagues.

On the point about energy, I think it is our responsibility within the sphere of work we do to be as active and effective as we possibly can. And we cannot possibly shed responsibility by saying the problem lies elsewhere. In the full scope of authority we have, our principal duty is to use that authority as effectively as we possibly can.

I think another part of our responsibility that you have touched on—and I think it is really implicit in larger discussion we have had—is our obligation to participate in larger discussions about what energy policy should be, larger discussions about how we live from what we see in our consumer protection and competition side, how we consume, how our lives are structured in a way that drives demand in certain directions, how people can make adjustments from existing lifestyles in ways that could affect consumption pat-

terns, and indeed, on the supply side, what challenges we face in ensuring that there are adequate supplies.

And I think beyond the narrow niche of competition and consumer protection, as important as those are to both of us, we would like to be part of that larger discussion about looking ahead as a country, what bigger challenges we must face in order to resolve these and related problems. We would eagerly enjoy being part of that discussion as well.

Senator BROWNBACK. Thank you, Mr. Chairman.

CREDIT CARD PRACTICES

Senator DURBIN. So you identified one of your concerns with financial services as subprime lenders and the like. I would like to ask you whether you have initiated any kind of inquiries or investigation into credit card practices.

Mr. LEIBOWITZ. Credit card practices are tricky for us because they are mostly done through banks, and we do not have jurisdiction over banks. It is one of the carve-outs, like common carriers and insurers, that we do not have jurisdiction over.

We do have a major investigation going on of a large subprime credit card non-bank company, CompuCredit, and I can make that public because they have made it public in, I think, their Securities and Exchange Commission (SEC) filings. So yes. The answer is yes. We are looking at this.

Senator DURBIN. I would think that the credit card aspect of this might come up in the identity theft investigations.

Mr. LEIBOWITZ. Of course, it does.

IDENTITY THEFT

Senator DURBIN. And that is your number one complaint. I think one out of three consumer complaints relate to identity theft.

Mr. LEIBOWITZ. That is right.

Senator DURBIN. Having been personally victimized a few years ago and my wife just recently—thank goodness, it was not any great damage to us. Tell me what you are finding. Are there things that we should be considering in terms of new legislation or new policies that might protect the privacy of American consumers?

Mr. LEIBOWITZ. Well, identity theft is a very major problem in America. Roughly 10 million people, according to our surveys, are victims of some sort of identity theft every year.

We are mostly an information clearinghouse on identity theft because, after all, a lot of identity theft is criminal. But we do a lot of education on this, and we have some identity theft brochures, and I believe 3 million people have copies of them.

Do I think that there is a need for more legislation? I would like to think about that and get back to you.

But I certainly think it is an area—and I think our staff certainly thinks it is an area—that we need to keep in the forefront because it affects so many Americans. And so we spend a lot of time on the education side, on the compiling of statistics side, and we are going to stay on top of it.

Mr. KOVACIC. I want to underscore Commissioner Leibowitz's observation about the importance of your support for our efforts to do education. This is an area where we think that with greater pre-

caution-taking, many Americans can avoid circumstances in which they are going to be vulnerable. We should begin the process of education at the earliest possible stages of our education system. That is, imagine building into grade school education equivalence of the precepts that I think many of us—well, of a certain age at least—tended to learn as school children. Do not take a ride home with a stranger. If someone approaches you that you do not know, you do not follow them around. Basic precepts that might be identified for an electronic age today. If it is someone you do not know that is reaching out to you, far more often than not, nothing good is going to come from that. To tell adults about how to be discreet in the way in which they disclose information about themselves. If you receive a telephone solicitation—we will assume it is a legitimate one seemingly—or if you receive solicitations over the Internet and you know that you do not have a bank account with the State National Bank and they are asking you to verify account information, that is certain to be a fraud.

So your continuing support for efforts both for us and for related public institutions to carry on that education function would be helpful, along with your support for our continuing efforts to work more extensively with other public institutions.

As my colleague mentioned, the serious wrongdoers I think will only be deterred in this area when we take their freedom away. That means prison sentences. That means criminal prosecution. And your encouragement and continuing assistance in our efforts to prepare matters for prosecution by the Department of Justice, by State prosecutors, by Assistant U.S. attorneys would be most valuable in this respect.

Mr. LEIBOWITZ. And I absolutely agree with that.

GREEN MARKETING

Senator DURBIN. If I could just have one last question, I think there is one area we have not touched on in the consumer side, and that is the so-called green marketing that you mentioned in your summary.

The FTC has been working to review environmental marketing guidelines, also known as Green Guides. What is the most common type of problem that you are finding when it comes to green advertising?

Mr. LEIBOWITZ. Well, what we are beginning to see with the proliferation of green advertising—of course, if it is accurate, that is very good. It is good for the environment, and it is good for consumers to have that option. What we are beginning to see—and we started this with a workshop process—is that some of the advertisements are sometimes exaggerated, and if an advertisement is deceptive, then we are going to do an investigation and perhaps bring a prosecution. We are just starting to look at this issue. We think most of the advertisements we are seeing are good and they are well-intended, but we are going to police this area. That is what we are supposed to be doing.

Mr. KOVACIC. If I can mention, Mr. Chairman, our recent workshop on packaging and green claims related to packaging I think underscored an issue that lies ahead which is in popular discourse in advertising you see common use of terms like "sustainable,"

"green," "green-friendly." I suppose in some way we have a general hunch about what these things mean, but there could be a source of confusion for consumers as a whole. What is a sustainable product?

Senator BROWNBACK. Or what does ecoshaped mean? A very handsome shape, too.

Mr. KOVACIC. That is right.

And one of the things we saw in our workshop was—I think our workshop will help be a catalyst for further efforts by a variety of private and not-for-profit associations to provide better definitions for these things, to help establish standards and focal points for providing meaningful definitions. That, in turn, is going to assist us in framing the revision of our guidelines themselves. And as my colleague mentioned, we are keenly attuned to instances in which someone says, give me $50, I will plant a tree in the rainforest, to focus more and more attentively on whether that tree gets planted.

Senator DURBIN. Thank you.

Senator Brownback.

Senator BROWNBACK. I have no further questions.

Senator DURBIN. Thank you. It has been a great hearing. You have a fascinating agency which has received high marks for its performance for America's taxpayers and our economy, and you should be proud to be part of it. And we are glad to have you as part of our appropriation. I thank you for your preparation for this hearing and your comments.

ADDITIONAL COMMITTEE QUESTIONS

We may send some written questions your way, and I hope you will have a chance to respond to them in a careful and expedient way. The hearing record is going to remain open for about 1 week until Wednesday, May 21, for other subcommittee members if they would care to submit questions as well.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

MERGER ACTIVITY

Question. During economic downturns like we're experiencing today, analysts have reported that merger activity tends to increase.

Has the FTC observed that trend in the past, and if so, does the fiscal year 2009 budget include an increase to accommodate the increase in anticipated workload?

Answer. The FTC's data show that the number of merger filings with the FTC and the Department of Justice tends to grow with increased merger and acquisition activity during strong economic times. The FTC has not observed that merger notifications tend to increase during economic downturns. Notwithstanding the current economic downturn, however, the FTC budget request for fiscal year 2009 includes an increase in resources devoted to reviewing mergers—resources that will be used to address the growing complexity of the transactions that the agency reviews and the increased need for sophisticated economic analysis of those transactions.

FRAUD COMPLAINTS

Question. The number of fraud complaints reported to the FTC grew by almost 30 percent in 2007.

What was the cause of the increase, and how will the fiscal year 2009 request address this problem?

Answer. This increase is due, in large part, to better data collection and specifically due to a substantial increase in complaints shared by the Better Business Bureaus ("BBBs"). We received 169,887 complaints from the BBBs in 2007, compared to 20,265 complaints in 2006.

The FTC maintains a broad range of consumer complaint data in Consumer Sentinel, which is a secure online database of millions of complaints that we make available to more than 1,700 law enforcement agencies. Numerous consumers complain directly to the FTC. At the same time, for many years, the agency has undertaken significant efforts to obtain complaints from other law enforcers combating fraud, such as the FBI, U.S. Postal Inspection Service, National Association of Attorneys General, and Australian Competition and Consumer Commission, as well as non-governmental entities, such as the BBBs. Pooling consumer complaint data from multiple sources enhances their utility for law enforcement, that is, bringing cases, and related purposes. For this reason, each year we strive to encourage new entities to share data with us and to increase the amount of data shared by existing contributors.

During fiscal year 2009, we will continue our efforts to increase complaint data sharing from our partners and, through outreach, encourage consumers to complain directly to the FTC. Our fiscal year 2009 budget request provides funds to support these important efforts.

SUBPRIME LENDING

Question. The FTC's fiscal year 2009 budget request includes an increase for protecting consumers from unfair and deceptive practices in the financial services marketplace.

What tools does the FTC have to investigate predatory lending practices? What specific steps has the FTC taken in the past year?

Answer. The FTC has effective tools for investigating lending practices that might violate any of the laws it enforces, which include the Truth in Lending Act ("TILA"),[1] the Home Ownership and Equity Protection Act ("HOEPA"),[2] and the Equal Credit Opportunity Act.[3] The Commission also enforces Section 5 of the Federal Trade Commission Act ("FTC Act"), which more generally prohibits unfair or deceptive acts or practices in the marketplace.[4] The FTC has jurisdiction over nonbank financial companies, including nonbank mortgage companies, mortgage brokers, and finance companies.

The full range of investigative tools available to the Commission in its other consumer protection investigations are available in its lending investigations. Most significantly, the FTC has the authority under Section 20 of the Federal Trade Commission Act to issue civil investigative demands to compel the recipient to provide documents, testimony, and other information to be used in determining whether the law has been violated and whether to commence a law enforcement action.

The Commission has been very active in investigating mortgage lending practices in the past year.[5] Among other things, in June 2007, the agency staff conducted a nationwide review of ads, including some in Spanish, featuring claims for very low rates or monthly payment amounts without adequate disclosure of other important loan terms. The FTC staff reviewed the ads to determine whether they may be deceptive in violation of Section 5 of the FTC Act or may violate TILA.[6] The Commission staff then commenced investigations of or sent warning letters to advertisers whose ads raised concerns. This included warning letters that FTC staff sent in September 2007 to more than 200 mortgage brokers and lenders, and media outlets that carry their advertisements for home mortgages, informing them that their ads may be unlawful. The agency staff recently reviewed the current advertising of those who received warning letters. We will take law enforcement action where ap-

[1] 15 U.S.C. §§ 1601–1666j (requiring disclosures and establishing other requirements in connection with consumer credit transactions).

[2] 15 U.S.C. § 1639 (providing additional protections for consumers who enter into certain high-cost refinance mortgage loans). HOEPA is a part of TILA.

[3] 15 U.S.C. §§ 1691–1691f (prohibiting creditor practices that discriminate on the basis of race, religion, national origin, sex, marital status, age, receipt of public assistance, and the exercise of certain legal rights).

[4] 15 U.S.C. § 45(a).

[5] The Commission's April 29, 2008 testimony before the Subcommittee On Interstate Commerce, Trade, and Tourism of the Committee On Commerce, Science, and Transportation, United States Senate provides a comprehensive description of the FTC's law enforcement, policy, and consumer education work in the subprime mortgage market in recent years. The testimony is available at http://www.ftc.gov/os/testimony/P064814subprimelending.pdf.

[6] See Press Release, FTC Warns Mortgage Advertisers and Media That Ads May Be Deceptive (Sept. 11, 2007), available at www.ftc.gov/opa/2007/09/mortsurf.shtm.

propriate if this review or other monitoring of mortgage advertising claims reveals that an advertiser has violated the law.

In addition, the FTC plays an important role in preventing unlawful mortgage discrimination.[7] At this time, the Commission is conducting several non-public investigations of mortgage originators for possible violations of fair lending laws.

The Commission has also been active in investigating unfair or deceptive practices by mortgage servicers. Recently, The Bear Stearns Companies, Inc. ("Bear Stearns") disclosed that FTC staff has notified its mortgage servicing subsidiary, EMC Mortgage Corporation ("EMC"), that the staff believes EMC and its parent Bear Stearns have violated a number of federal consumer protection statutes in connection with its servicing activities. Bear Stearns further disclosed that FTC staff offered an opportunity to resolve the matter through consent negotiations before seeking approval from the Commission to proceed with the filing of a complaint. According to the disclosure, EMC expects to engage in such discussions with Commission staff.[8] The FTC cannot comment further on this ongoing law enforcement investigation.

Previously, in 2003, the Commission, along with HUD, announced a settlement of allegations that Fairbanks Capital Corp. (now called Select Portfolio Servicing, Inc.) failed to post consumers' payments upon receipt, charged unauthorized fees, used dishonest or abusive tactics to collect debts, and reported to credit bureaus consumer payment information that it knew to be inaccurate.[9] In late 2007, based on a compliance review of the company, the Commission negotiated modifications to the 2003 consent order. The modified consent order provides substantial benefits to consumers beyond those in the original order, including additional refunds of fees paid in certain circumstances.[10]

The Commission continues to investigate mortgage servicing practices for compliance with the law.

In an effort to enhance interagency coordination, the FTC, the Federal Reserve Board ("FRB"), the Office of Thrift Supervision, and two associations of state regulators have combined forces to undertake an innovative law enforcement project. The agencies are jointly conducting consumer protection compliance reviews and investigations of certain nonbank subsidiaries of bank holding companies with significant subprime mortgage operations.[11]

Finally, the Commission works to protect consumers of subprime unsecured loans. In June 2008, for example, the Commission filed a lawsuit charging subprime credit card company CompuCredit Corporation ("CompuCredit") and its affiliate with deception in marketing credit cards.[12]

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[7] The Commission's July 25, 2007 testimony before the Subcommittee on Oversight and Investigations of the House Committee on Financial Services detailed the Commission's fair lending program. The testimony is available at www.ftc.gov/os/testimony/P064806hdma.pdf.

[8] Form 10–K, Bear Stearns Mortgage Funding Trust 2007–AR4 (CIK No. 1393708), at Item 1117 of Reg AB, Legal Proceedings (filed Mar. 31, 2008), available at www.sec.gov/Archives/edgar/data/1393708/000105640408001164/0001056404-08-001164.txt.

[9] *United States* v. *Fairbanks Capital Corp.*, No. 03–12219 (D. Mass. 2003). The settlement agreement included a $40 million redress fund for consumers as well as strong injunctive provisions and specific safeguards to prevent the company from foreclosing on consumers without cause.

[10] *United States* v. *Fairbanks Capital Corp.*, No. 03–12219 (D. Mass. Sept. 4, 2007) (Modified Stipulated Final Judgment and Order).

[11] See Press Release, FTC, Federal and State Agencies Announce Pilot Project to Improve Supervision of Subprime Mortgage Lenders (July 17, 2007), available at www.ftc.gov/opa/2007/07/subprime.shtm.

[12] *FTC* v. *CompuCredit Corp.*, No. 1:08cv1976–BBM–RGV (N.D. Ga. 2008). The FTC's complaint alleges, among other things, that CompuCredit marketed to consumers with subprime credit ratings a Visa credit card purportedly providing $300 in credit, using solicitations that touted in bold headlines that certain up-front fees that did not apply. Rather than provide consumers with $300 of available credit, CompuCredit allegedly immediately charged consumers as much as $185 in fees that it did not disclose adequately in light of the representations made. These fees left consumers with as little as $115 in available credit. The FTC alleges that CompuCredit deceived consumers in violation of Section 5 of the FTC Act by misrepresenting the amount of credit available.

With respect to another Visa credit card CompuCredit offered, the FTC alleges CompuCredit marketed to consumers with slightly higher credit scores its Visa credit card purporting to offer "up to $3,250" in available credit and touted that the card could be used for any purpose. The FTC alleges, however, that CompuCredit misrepresented the amount of available credit because it withheld 50 percent of that credit for 90 days. CompuCredit allegedly also failed to disclose, or failed to disclose adequately, that for the first 90 days, the company would monitor consumers' purchases, and might reduce their credit limit based on an undisclosed "behavioral" scoring model. The Commission alleges that CompuCredit's misrepresentation as to the amount of available credit and its failure to disclose adequately that the types of purchases consumers

Continued

Question. Are there steps that the FTC would have liked to have taken that it could not because of limits or restrictions in the FTC's authorities?

Answer. The Commission generally believes that the scope of its legal authority has not prevented the agency from taking steps to address the acts and practices of those within its jurisdiction related to subprime mortgage lending, although the Commission currently lacks authority to seek civil penalties for HOEPA violations. The FTC, however, notes that the FRB recently finalized rules under HOEPA and TILA that will prohibit specific mortgage lending and related practices the FRB determined were unfair and deceptive under the HOEPA.[13] Both the federal banking agencies and the FTC can enforce the new rules as to the entities they regulate. We note, though, that the federal banking agencies have the authority to obtain civil penalties against entities they regulate who violate the new rules, while the FTC does not.[14] Enacting legislation allowing the FTC to obtain civil penalties against entities within the FTC's jurisdiction who violate the new rules would allow the FTC to enforce the rules more effectively and better protect consumers in the subprime mortgage market, and it would level the playing field such that all entities subject to HOEPA could be subject to civil penalties. We particularly appreciate the inclusion of provisions in the Committee's fiscal year 2009 appropriations bill that would authorize the FTC to obtain civil penalties for violations of rules under HOEPA.

Question. FTC testimony states that the agency has sent warning letters to 200 mortgage lenders about misleading mortgage advertisements—for example, promoting low "teaser rates" without explanation of long-term rates. Are these warning letters a strong enough punishment? Why hasn't the FTC taken enforcement action against these lenders?

Answer. As explained above, the FTC is following up on these warning letters with law enforcement, where appropriate. Currently, the Commission is investigating a number of mortgage originators for potential deceptive advertising.

Question. To what extent is the FTC coordinating with other agencies (such as the FBI, the SEC, and HUD) in pursuing predatory lending?

Answer. The Commission coordinates regularly on financial practices matters with federal banking agencies, the Department of Justice, and HUD. For more than a decade, the FTC has been a member of the Interagency Task Force on Fair Lending, a joint undertaking with DOJ, HUD, and the federal banking regulatory agencies. Task Force members meet often to share information on lending discrimination, predatory lending enforcement, and policy issues. The Commission also has had several conversations with SEC representatives about the subprime mortgage market, although our law enforcement activities focus on different practices in the mortgage industry.

Further, FTC staff are coordinating with other governmental entities to combat foreclosure rescue fraud. Commission staff are participating in task forces concerning foreclosure rescue fraud in seven geographic areas. Task force members in each local area share information about trends in consumer complaints and work to identify solutions. For example, the FTC's Southeast Regional Office is working with a state attorney general's office to identify, investigate, and prosecute cases. These efforts include close coordination on cases under investigation. In some cases, the two agencies have divided responsibility for law enforcement actions; in other cases, the two agencies are working cooperatively on particular targets. The FTC's East Central Regional Office is partnering with a local task force to implement various consumer education and outreach strategies to help consumers. The Southern California Foreclosure Fraud Task Force, in which the FTC's Western Region par-

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made could reduce their credit limit were deceptive acts and practices in violation of Section 5 of the FTC Act. The FTC's litigation with CompuCredit is ongoing.

[13] The rules add four protections for a newly defined category of "higher-priced" mortgage loans: (1) they prohibit a lender from making a loan without regard to borrowers' ability to repay the loan; (2) they require creditors to verify the income and assets they rely upon to determine repayment ability; (3) they restrict prepayment penalties; and (4) they require creditors to establish tax and insurance escrow accounts for all first-lien mortgage loans. The rules also prohibit creditors and mortgage brokers from coercing a real estate appraiser to misstate a home's value. And the rules prohibit mortgage servicers from engaging in certain practices, such as pyramiding late fees. The rules also impose specific advertising standards, banning seven deceptive or misleading advertising practices, including representing that a rate or payment is "fixed" when it can change.

[14] Under the Federal Deposit Insurance Act, 12 U.S.C. Section 1818(i)(2), federal banking agencies can obtain civil penalties from the entities they regulate who violate the laws they enforce, including TILA and its implementing regulations. The FTC has no comparable authority to obtain civil penalties from the nonbank entities it regulates for violations of TILA and its implementing regulations.

ticipates, has facilitated the coordination of prosecutions by civil and criminal authorities at various levels.

U.S. SAFE WEB ACT

Question. The U.S. SAFE WEB Act, enacted in December 2006, expanded the FTC's authorities to coordinate with foreign law enforcement against spam and other unfair and deceptive practices involving foreign commerce. The FTC's fiscal year 2009 budget request includes additional funding for staff to pursue foreign-located fraud.

How many FTE are currently dedicated to implementing the U.S. SAFE WEB Act, and how would additional staff enhance that effort?

Answer. Because the statute provides a wide range of authorities to the agency, a number of staff members in a number of offices throughout the agency are involved in implementing it. FTC's Office of International Affairs ("OIA"), which helped develop the Act and works to advance international enforcement cooperation, leads the implementation, including chairing an agency-wide steering group of 9 people and several additional ad hoc members for particular issues. At least six attorneys in OIA devote substantial time to implementing the Act, including the Act's provisions on information sharing, investigative assistance, international agreements, cooperation on foreign judgment enforcement and asset recovery, enforcement networks and projects, and foreign staff exchange programs (i.e., the FTC's new "International Fellows" program). In addition, a number of other staff members within OIA as well as in the Bureau of Consumer Protection, the Office of the General Counsel, the Executive Director's Office, and others are involved in implementing and making use of the SAFE WEB authority.

We would use additional staff to enhance our efforts on foreign judgment enforcement and asset recovery for American consumers, information sharing and investigative assistance, and our International Fellows program. We are addressing increasing numbers of requests for information sharing and investigative assistance regarding cross-border matters that may aid FTC enforcement actions or may halt frauds targeting U.S. consumers among others. In addition, we are expanding our International Fellows program to provide opportunities for foreign officials to learn first-hand how the FTC operates and for FTC staff similarly to learn about agencies abroad, thereby improving the ability of the agencies to coordinate and cooperate on law enforcement matters. We are also working to take advantage of our enhanced ability through SAFE WEB to enforce judgments against foreign defendants. With more staff, we can manage additional use of these and other SAFE WEB tools to protect American consumers from cross-border fraud.

Question. What are the biggest obstacles to enforce against foreign fraud? How is the FTC addressing these obstacles?

Answer. The biggest obstacle to enforcing against foreign fraud is the ability of unscrupulous businesses operating in one jurisdiction to evade enforcement by using the Internet and long distance telephone technology to victimize consumers globally and hide behind national borders and laws. In particular, these actors often exploit the inability of many foreign law enforcement agencies to identify schemes and targets and share information about them in a timely and effective manner because of antiquated laws and regulations.

As described above, the FTC is using the tools of the SAFE WEB Act to address these obstacles. The key to combating cross-border fraud is developing better and quicker enforcement cooperation with foreign law enforcement agencies, including information sharing and investigative cooperation. While the FTC has always acted aggressively to combat cross-border fraud, since the Act went into effect at the end of 2006 and implementing regulations in the spring of 2007 the FTC has been able to obtain heightened success by using the tools of the SAFE WEB Act. For example, the FTC's enforcement action against Spear Systems, Inc., alleging international illegal spamming, was significantly enhanced by the agency's use of its information sharing powers under SAFE WEB. Information sharing authorized under SAFE WEB assisted Canadian law enforcement agencies with regard to several cases targeting telemarketing schemes that allegedly defrauded U.S. consumers, as part of the FTC's 2008 Telemarketing Sweep—"Operation Tele-PHONEY." The U.S. SAFE WEB Act has been pivotal in allowing the FTC to take the lead globally in combating cross-border fraud and in encouraging our foreign law enforcement partners to revise their laws in light of the global nature of mass-marketing fraud.

GAS PRICES

Question. The FTC's 2006 study on nationwide gas prices [15] concluded that rising prices could be explained entirely by market forces, not illegal anticompetitive behavior or other activity designed to increase prices relative to costs or to reduce output.

Commissioner Leibowitz filed a dissent to the 2006 report, writing: ". . . the question you ask determines the answer you get: whatever theoretical justifications exist don't exclude the real world threat that there was profiteering at the expense of consumers."

Is the FTC asking the wrong questions when it comes to investigating these high gas prices? And if so, what is the right question to ask so that we can get to the heart of what Commissioner Leibowitz calls "profiteering at the expense of consumers?"

Answer. For the most part the Agency is asking the right questions, especially today. But I was hoping that the 2006 gas price investigation and the resulting report would cover potential misconduct by oil companies. Instead, staff constructed a theoretical model of legitimate behavior and attempted to determine whether that model could explain gas prices (we could not have uncovered anticompetitive conduct by oil companies because we were not looking for it). To be fair, and as I noted in my 2007 statement, when we began the investigation for the 2006 Report, staff had just finished a major report relating the gas price run-up in the wake of hurricanes Katrina and Rita.[16] In that investigation, staff found no antitrust violations but did find what in my view was inappropriate profit-taking by the oil companies in the wake of a disaster, including price-gouging as that term was defined by Congress.

Going forward, the Commission, in its ongoing rulemaking proceeding, is considering assessing conduct under a standard set out in the Energy Independence Security Act of 2007. To the extent that the profiteering was a result of manipulation of gas prices by individual oil companies, it is possible that a result of the rulemaking proceeding may make it easier to prevent that in the future.[17]

The report on the 2006 nationwide price increases was not based on theoretical justifications. Rather it was an analysis and description of the factual evidence of the economic developments actually experienced that could account for the price spikes: facts concerning upward price pressure stemming from seasonal effects on both the demand for and the supply of gasoline, increases in prices for crude oil and ethanol, reductions in refining capacity due to the transition to ethanol, and other identified market factors. This fact-based analysis led to the conclusion that such developments adequately explained the 2006 price increases and that the price phenomena did not indicate anticompetitive conduct.

With respect to the right question to address "profiteering at the expense of consumers," this has to depend on what is meant by "profiteering." To the extent it is intended to refer to the sheer size of profits, decisions on how to address this, such as through fiscal policy or price controls, are very fundamental policy determinations that are properly reserved for Congress. The Commission, however, must—and does—continue zealously to seek out and prevent any violations of the antitrust laws, including those that illegally raise prices and profits. Furthermore, Congress has given the Commission authority with respect to manipulative or deceptive devices or contrivances regarding this industry, and, as Commissioner Leibowitz notes above, the Commission is currently engaged in a rulemaking proceeding under this authority.

Question. Commissioner Leibowitz cited that among other things, the investigation found "disturbing conduct by . . . petroleum companies."

What disturbing conduct did the FTC observe? What action did the FTC take, and does the agency continue to see this kind of behavior?

Answer. As described above, the Katrina Report found that there was price gouging (under the Congressional definition) by some oil companies in the wake of

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[15] Federal Trade Commission Report On Spring/Summer 2006 Nationwide Gasoline Price Increases (August 2007) (available at http://www.ftc.gov/reports/gasprices06/P040101Gas06increase.pdf); Dissenting Statement of Commissioner Jon Leibowitz Regarding the Federal Trade Commission and Department of Justice Antitrust Division Report on Spring/Summer 2006 Nationwide Gasoline Price Increases (available at http://www.ftc.gov/reports/gasprices06/P010401Gas06dissent.pdf).

[16] See Dissenting Statement at 1; see also Federal Trade Commission Report on the FTC's Investigation of Gasoline Price Manipulation and Post-Katrina Price Increases (May 2006) (available at http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf).

[17] Information on the Commission's rulemaking proceeding is available at http://www.ftc.gov/ftc/oilgas/index.html.

the disaster. And it is disturbing that oil companies made record profits even as many consumers suffered from high energy prices in the affected area. The conduct found was not a violation of the antitrust laws however. Going forward, the Commission, in its ongoing rulemaking proceeding is considering assessing conduct under a standard set out in the Energy Independence Security Act of 2007 and it may ultimately be that we look at certain oil company behavior using a broader definition of misconduct.

Neither the major investigation reported in the Katrina report nor the careful analysis the following year of the 2006 price spikes showed evidence of behavior inconsistent with competitive responses to market conditions. In particular, with respect to the Katrina aftermath, the agency's extensive investigation found that the market, including price increases for a period of time, functioned appropriately to enable increased supply to flow into the affected areas and to reduce prices to consumers swiftly. With respect to the "price gouging" identified in the Commission's post-Katrina report, in fifteen instances prices met the statutory definition of "price gouging" laid down for the study, but all except one were explainable by identifiable market factors other than those incorporated into that definition. As noted, the agency continues to scrutinize the industry carefully to identify possible anticompetitive activity, and to investigate and take enforcement action whenever warranted. In addition, as noted, the agency is conducting a rulemaking proceeding under its new authority to prohibit manipulative or deceptive devices or contrivances and our expectation is that this proceeding will be completed this year.

RESOURCES FOR PRICE MONITORING

Question. The President ordered the 2006 study of nationwide gas prices in April of 2006, yet the FTC report was published in August 2007—a full 16 months later.

If the FTC is conducting real-time monitoring of gas prices for anticompetitive behavior, why did it take 16 months to come to a conclusion on this study? How can the FTC stop oil companies in their tracks if investigations take this long?

Answer. The inquiry into the 2006 price increases—conducted jointly with the Department of Justice and with assistance from the Department of Energy's Energy Information Administration—focused on the gasoline price increases experienced nationwide in the spring and summer of that year. The inquiry identified six broad market factors that appeared to contribute to the national average price increases during the spring and summer of 2006: seasonal effects, increases in crude oil prices, increases in ethanol prices, capacity reductions due to the transition to ethanol, reductions in refiners' ability to produce gasoline, and increases in demand. It required careful financial and economic analysis of price and cost data spanning an extended period of time, supplemented by interviews with refiner personnel and a review of key company documents, to identify the relative contribution of each factor to the price increases and conclude that those market factors provided an adequate explanation for the price increases without giving rise to an inference of anticompetitive behavior.

In this instance, the FTC Gasoline and Diesel Price Monitoring Project was of limited value in explaining the nationwide, average increases, because the project's model is designed to focus on a different phenomenon—i.e., whether an observed difference between two retail or wholesale areas' local gasoline or diesel prices departs from the difference that one would expect based on historical statistical relationships.

As you know, the FTC is primarily a law enforcement agency rather than a supervisory or regulatory agency. As a law enforcement agency, the FTC is empowered to take legal action to challenge suspect behavior under the federal laws it enforces. In such proceedings, the FTC must meet burdens of proof as determined by the relevant statutes and as interpreted by the federal courts. For practices that do violate a federal law, the FTC has available a wide variety of remedies to halt the practices and reverse their harmful results. I also note that the task involved in this investigation is not necessarily the same as that of a law enforcement investigation, which may stem, for example, from a merger filing, information on specific company acts, or a more localized or straightforward pricing anomaly rather than a nationwide price movement.

Question. Does the FTC have sufficient resources to analyze the oil and gas markets quickly enough to promptly act and stop anticompetitive behavior?

Answer. The FTC believes that its fiscal year 2009 funding request would provide sufficient resources to meet the agency's Consumer Protection and Maintaining Competition goals, including those involving oil and gas markets. I note, however, that the budgets that serve as the basis of the appropriations requests are prepared many months before requests are submitted to Congress, and they cannot always

predict changes to the agency's work that are dictated by emerging events or Congressional directives or requests. A recent example of this is the new statutory authority Congress gave the FTC to prescribe anti-manipulation rules in the energy sector. The Commission will continue, as it has in the past, to redistribute existing resources to meet these new demands, while assessing the need for additional resources.

PRICE GOUGING

Question. What is the FTC's opinion on federal anti-price gouging legislation? On the state level, has the agency observed a deterrent effect? Would federal price gouging laws enhance state laws?

Answer. The Commission has testified on several occasions that federal price gouging legislation likely would harm consumers by reducing the incentives and increasing the risks for refiners to move additional supply into affected areas and take other steps to respond to market forces after natural disasters.[18] After Hurricanes Katrina and Rita in 2005, gasoline prices briefly spiked higher in many parts of the country. Consumers understandably are upset when they face dramatic price increases within very short periods of time, especially during a disaster. But price gouging laws—particularly inasmuch as they could well deter firms from taking beneficial steps to respond to post-disaster shortages—likely will do consumers more harm than good. Law enforcement actions premised on a notion of restricting price increases essentially are a form of price control, which could produce longer lines at the pump and prolong the gasoline crisis. Although no consumer likes price increases, such an increase in fact can help to make the gasoline shortage less intense and shorter-lived than it otherwise would have been.

Prices play a critical role in our economy: they signal producers to increase or decrease supply, and they also signal consumers to increase or decrease demand. In a period of shortage—particularly with a product, like gasoline, that can be sold in many markets around the world—higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. For instance, sharp increases in the price of gasoline can help curtail the panic buying and "topping off" practices that cause retailers to run out of gasoline. In addition, higher gasoline prices in the United States in the wake of the 2005 hurricanes resulted in the shipment of substantial additional supplies of foreign gasoline to the United States.[19] If price gouging laws distort these natural market signals, markets may not function well and consumers would be worse off.

To be sure, there may be situations in which sellers go beyond the necessary market-induced price increase. A seller might misjudge the market and attempt to charge prices substantially higher than conditions warrant or than its competitors are charging. News stories of gasoline retailers panicking and setting prices of $6.00 per gallon after Katrina are evidence of such misjudgments. But the market—not price gouging laws—is the most effective cure for these. Temporary prices that are wildly out of line with competitors' prices do not last when consumers quickly discover that other stations are charging lower prices. A single seller in a market structured like gasoline retailing cannot unilaterally raise prices for long above the level justified by supply and demand factors. The few retailers who raised prices to the $6.00 level reduced them just as quickly when it became apparent that they had misjudged the market.

A price gouging law likely would be difficult to enforce fairly. The difficulty for gas station managers, as well as for enforcers, often is knowing when the managers have raised prices "too much," as opposed to responding to reduced supply conditions. It can be very difficult to determine the extent to which any more moderate price increases are necessary. Examination of extant state price gouging laws and of the federal gasoline price gouging legislation that has been introduced indicates

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[18] Commissioner Leibowitz notes that, as he has stated in his concurrence to the Commission's report "Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases," twenty-nine states and the District of Columbia have price gouging laws that provide for either civil or criminal penalties and, in some situations, both. Six of these states and the District of Columbia expressly are permitted by their statutes to cap price increases during an emergency. Most of these price gouging statutes require an emergency declaration and, to the Commissioner's mind, seem entirely unthreatening to the operation of the free market—and, indeed they may serve a salutary purpose of discouraging outliers from profiteering in the aftermath of a disaster.

[19] Total gasoline imports into the United States for September and the first three weeks of October 2005 (after the August hurricanes) were approximately 34 percent higher than imports over the same seven-week period in 2004. See U.S. Dep't of Energy, Energy Information Admin., U.S. Weekly Gasoline Imports (Oct. 26, 2005), available at http://www.eia.doe.gov/oil__gas/petroleum/info__glance/gasoline.html.

that the offense of "price gouging" is difficult to define. For example, some bills define "gouging" as consisting of a 10 or 15 percent increase in average prices, while most leave the decision to the courts by defining gouging in nebulous terms such as "gross disparity" or "unconscionably excessive." Some, but not all, make allowances for the extra costs that may be involved in providing product in a disaster area. Few, if any, proposed federal bills or state laws take account of market incentives for sellers to divert supply from their usual customers in order to supply the disaster area, or incentives for consumers to reduce their purchases as much as possible, minimizing the shortage. Ultimately, the inability to agree on what should be prohibited indicates the risks in developing and enforcing a federal statute that could be counterproductive to consumers' best interest. Moreover, much legislation provides substantial criminal penalties for those found guilty of "price gouging"—a feature of the legislation that is likely to persuade significant numbers of merchants to close down operations rather than run the risk of going to prison for raising prices enough to cover ongoing costs and maintain adequate supplies.

For all of these reasons, a majority of the Commission has concluded that federal price gouging legislation would harm consumers overall.

The Commission has not studied state price gouging laws in depth to determine if they actually have any deterrent effect.[20] Because of the potential overall harm to consumers of price gouging laws, I cannot say that a federal law would be likely to enhance the states' ability to protect consumers.

STRATEGIC PETROLEUM RESERVE

Question. A provision suspending the acquisition of petroleum for the Strategic Petroleum Reserve passed the Senate recently. Based on the FTC's historical models, would the suspension have significant effect on prices a the pump?

Answer. As noted above, the FTC's Gasoline and Diesel Price Monitoring Project—with its focus on historical differences in local gasoline or diesel prices in retail or wholesale areas—is not designed to predict how changes in crude oil availability might affect crude oil prices or gasoline or diesel prices. Accordingly, the Monitoring Project model cannot provide any insight into the possible effects on prices at the pump of a suspension of additions to the Strategic Petroleum Reserve.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

GASOLINE PRICES

Question. On May 23, 2007, the FTC testified before the Joint Economic Committee that "mergers of private oil companies have not significantly affected worldwide concentration in crude oil. This fact is important, because crude oil prices historically have been the chief determinant of gasoline prices." Given the fact that the share of gasoline prices attributable to crude oil costs haves risen to 71.8 percent from around 50 percent a year ago, would you say that crude oil costs are likely an even stronger determinant today?

Answer. The average spot price of crude oil, as reported by the Energy Information Administration, nearly doubled between May 2007 and May 2008, from a monthly average of $67 per barrel to approximately $125 per barrel. Crude oil prices rose even more after May 2008, varying daily between about $130 and $145 per barrel during June and the first three weeks of July. This increase in crude oil prices has by far outstripped changes in any other element relevant to the production of gasoline. Crude oil prices are a stronger determinant of gasoline prices today because any given percentage change in crude oil prices from current levels will have a greater impact on pump prices than in previous years, when crude oil prices were dramatically lower.

ETHANOL

Question. Has the FTC looked at concentration in the ethanol market? Is concentration increasing or decreasing?

Answer. The FTC has closely scrutinized and reported on production and concentration in the United States ethanol market since late 2005. In November 2007, the Commission issued its third annual report on the U.S. industry. The series of FTC reports shows that concentration in the industry has been decreasing. The 2007 report noted that, as of September 2007, 13 firms had entered into the produc-

[20] The Commission's report following Hurricanes Katrina and Rita noted that the prices of nearly all the retailers subjected to state enforcement actions were consistent with market trends or other market-based factors.

tion of ethanol during the preceding year, bringing the total number of U.S. producers to 103.[21] As new firms have entered, the market, which is unconcentrated by any measure of capacity or production, has become even more unconcentrated.

TELECOMMUNICATIONS

Question. The proposed Reauthorization bill S. 2831, which is currently before the Senate Commerce Committee, proposes a waiver of the telecommunications common carrier exemption. This exemption bars the agency from reaching certain conduct of telecommunications companies. The Commission has testified in favor of the repeal of the exemption. However in seeking this new authority, the FTC has never cited an instance where the FCC failed to fulfill its responsibilities. The Telecommunications Consumers Division within the FCC's Enforcement Bureau investigates the practices of companies engaged in various telecommunications-related activities. So, the FCC already is exercising its statutory authority in the precise areas in which the FTC seeks jurisdiction. If this exemption were to be lifted what would be the benefit? What could the FTC accomplish or reach that is not currently dealt with? Because, to permit two different agencies to impose regulations covering the same type of conduct could very easily become unduly burdensome on companies, while not providing a corresponding benefit to or protection for consumers.

Answer. The FTC's request that Congress repeal the FTC Act exemption for common carriers as applied to providing telecommunication services is not a commentary on or reflection of concern about the work done by the FTC's sister agency, the Federal Communications Commission. Indeed, over the years, the FTC has worked closely with the FCC on numerous issues of joint interest. Currently, the two agencies coordinate enforcement of their overlapping Do Not Call rules, and the FCC is a member of the federal-state law enforcement task force on prepaid calling cards that the FTC established last year.

The two agencies, however, have very different missions and law enforcement tools. The FTC is the nation's consumer protection authority and, as such, has extensive experience investigating and bringing federal court and administrative actions against companies engaged in deceptive and unfair practices. As a result, the FTC has substantial litigation experience and a robust body of case law to rely on in seeking to stop deceptive or unfair acts and practices that harm consumers, and to get money back for injured consumers.

The common carrier exemption dates from a period when telecommunications were provided by highly-regulated monopolies. The exemption as applied to telecommunications services is now outdated, and the FTC has repeatedly found its consumer protection work impeded by the exemption in ways that are detrimental to consumers. Most recently, the common carrier exemption has been an issue in two FTC cases against the distributors of prepaid calling cards. In those cases, the FTC has alleged that the distributors engaged in deceptive marketing practices by misrepresenting the number of calling minutes provided by their cards and failing to disclose or to adequately disclose fees and charges associated with their cards. *FTC* v. *Clifton Telecard Alliance One LLC*, No. 2:08–cv–01480–PGS–ES (D.N.J.) (filed March 25, 2008); and *FTC* v. *Alternatel, Inc.*, No. 08–21433–CIV-Jordan/McAliley (S.D. Fla.) (filed May 19, 2008).[22] In both cases, the FTC sought and received temporary restraining orders prohibiting defendants from, inter alia, misrepresenting the number of calling minutes provided by the cards they distribute, and failing to disclose fees and charges that reduce the value of their calling cards. Because of the common carrier exemption, the FTC has not pursued the carriers that provide the telecommunications services for the cards at issue. As a result, in both cases the defendants have moved to dismiss the FTC's case on the grounds that the underlying telecommunications carriers are necessary parties that cannot be joined by the FTC, because of the common carrier exemption. Although the FTC has opposed defendants' motions, and is confident that it will win on the merits, the exemption has created a litigation issue for the FTC. More fundamentally, the exemption directly impedes the FTC's ability to hold carriers accountable for their role in allegedly deceptive and unfair practices in the calling card industry.

The prepaid calling card industry is not an isolated example of an area in which the common carrier exemption hampers the FTC's ability to protect consumers from deceptive and unfair acts or practices. As information, entertainment, and payment systems converge, common carriers are providing an increasing number of new serv-

[21] Federal Trade Commission, 2007 Report on Ethanol Market Concentration (Nov. 2007), available at http://www.ftc.gov/reports/ethanol/2007ethanol.pdf.

[22] In the *Clifton* case the Commission has also alleged that defendants failed to disclose or to adequately disclose that the value of their cards may be reduced even when a call does not connect.

ices. Now, consumers can purchase their voice services bundled with Internet access services and video services. Moreover, landline and cellular carriers bill consumers for unlimited numbers of services provided by third parties. The FTC has brought dozens of cases against companies that the FTC alleges have crammed unauthorized charges onto consumers' phone bills.[23] The common carrier exemption, however, has given rise to issues that complicate litigation in some of these cases,[24] and has impeded the Commission's ability to consider whether and to what extent phone companies should be held responsible for placing those charges on their customers' phone bills.

MORTGAGE MARKETING

Question. Could you elaborate for the record on some of the most egregious examples of unfair and deceptive advertising that the FTC has reviewed in connection with mortgage brokerage activities? What are the underlying themes—is it rates that adjust after a month, unclear disclosures of what the terms are, failure to disclose that the quoted terms didn't include escrow information clearly, or represented a type of bait and switch approach? Just give us a flavor of some of the most significant aspects of this type of marketing.

Answer. The Commission has been actively investigating mortgage lending practices for many years.[25] In June 2007, the agency staff conducted a nationwide review of mortgage ads, including some in Spanish, featuring claims for very low rates or monthly payment amounts without adequate disclosure of other important loan terms. The FTC staff reviewed the ads to determine whether they may be deceptive in violation of Section 5 of the FTC Act or may violate the Truth in Lending Act ("TILA").[26] The Commission staff then commenced investigations of or sent warning letters to advertisers whose ads raised concerns. This included warning letters that FTC staff sent to more than 200 mortgage brokers and lenders, and media outlets that carry their advertisements for home mortgages, informing them that their ads may be unlawful. The agency staff recently reviewed the current advertising of those who received warning letters. We will take law enforcement action where appropriate if this review or other monitoring of mortgage advertising claims reveals that an advertiser has violated the law.

Through our deceptive mortgage advertising sweep and other monitoring of mortgage ads, the FTC has reviewed many mortgage ads for problematic claims. The ads frequently tout the most favorable terms of a mortgage without revealing critical facts consumers need to make well-informed decisions. We have encountered numerous ads offering low rates or monthly payments without disclosing adequately significant limitations or conditions. For example, an ad may tout that a mortgage is available with only "1 percent Payments," yet fail to disclose that 1 percent is not an interest rate or that this payment rate only applies during a brief introductory period. We have also encountered ads offering loans with "fixed" low rates or monthly payments which in fact are loans with adjustable rates or payments. For instance, an ad may state in large bold print, "30-Year Fixed, 1.99 percent." Only at

[23] See, e.g., *FTC* v. *Verity International Ltd.*, 335 F. Supp. 2d 479 (S.D.N.Y. 2004), aff'd in part, rev'd in part, 443 F.3d 48 (2d Cir. 2006), cert. denied, 127 S. Ct. 1868 (2007); *FTC* v. *Nationwide Connections, Inc.*, No. 06–80180–CIV-Ryskamp/Vitunack (S.D. Fla. 2006); *FTC* v. *Websource Media, LLC.*, No. H–06–1980 (S.D. Tex. 2006); *FTC* v. *Epixtar Corp.*, No. 03–CV–8511 (DAB) (S.D.N.Y. 2003); *FTC* v. *Sheinkin*, No. 2–00–363618 (D.S.C., 2000); *FTC* v. *Mercury Marketing of Delaware, Inc.*, No. 00–CV–3281 (E.D. Pa. 2000); *FTC* v. *Int'l Telemedia Assocs., Inc.*, No. 1–98–CV–1925 (N.D. Ga. 1998); *FTC* v. *Audiotex Connection, Inc.*, No. C–97 0726 (DRH) (E.D.N.Y. 1997).

[24] For example, in *FTC* v. *Verity International Ltd.*, the Commission alleged that the defendants orchestrated a scheme whereby consumers seeking online entertainment were disconnected from their regular ISPs and reconnected to a Madagascar phone number. The consumers were then charged between $3.99 and $7.78 per minute for the duration of each connection. AT&T and Sprint—which were not parties to the FTC enforcement action—had carried the calls connecting the consumers' computers to the defendants' servers. The defendants therefore argued that the entertainment service in question was provided on a common carrier basis and thus outside the FTC's jurisdiction. One defendant also claimed to be a common carrier itself and hence beyond FTC jurisdiction. Although both the District Court and the Court of Appeals rejected those arguments, the FTC had to expend substantial time and resources litigating the question of jurisdiction.

[25] The Commission's April 29, 2008 testimony before the Subcommittee On Interstate Commerce, Trade, and Tourism of the Committee On Commerce, Science, and Transportation, United States Senate provides a comprehensive description of the FTC's law enforcement, policy, and consumer education work in the subprime mortgage market in recent years. The testimony is available at http://www.ftc.gov/os/testimony/P064814subprimelending.pdf.

[26] See Press Release, FTC Warns Mortgage Advertisers and Media That Ads May Be Deceptive (Sept. 11, 2007), available at www.ftc.gov/opa/2007/09/mortsurf.shtm.

the bottom or reverse side, in tiny print, will it reveal that it is only fixed for the first year, and that after that will increase every year by as much as 7 percent.

DEBT RELIEF

Question. Can you outline examples of some of the most egregious cases of consumer fraud that you've witnessed in the Debt Relief/Debt Counseling arena? Obviously, people are hurting and looking for hope when they go to these services. What characteristics delineate the legitimate players in the market from those simply looking to prey upon desperate people?

Answer. The Commission has prosecuted about a dozen companies that it alleged falsely promised lifelines to consumers overwhelmed with credit card debt.[27] Some examples of egregious alleged conduct include the following cases:

In its largest case in this area, the FTC sued AmeriDebt, Inc., a purported credit counseling organization.[28] The Commission alleged that AmeriDebt deceived consumers with claims that it was a non-profit organization that provided bona fide debt counseling services. In fact, the FTC alleged, AmeriDebt funneled profits to affiliated for-profit entities and individuals. The Commission also alleged that AmeriDebt deceived customers by claiming that it did not charge an up-front fee when, in fact, AmeriDebt kept its clients' first payments as a fee, rather than disbursing the money to their creditors as promised. The FTC's settlement with AmeriDebt, which filed for bankruptcy during the litigation, bans the company from the industry. Subsequently, on the eve of trial, AmeriDebt's founder agreed to a $35 million settlement.[29]

In another case, the Commission sued a Canadian telemarketer, alleging that it preyed on American consumers by falsely promising that, for an upfront fee of $700, it would provide interest rate reduction services for consumers with high-interest credit cards.[30] Although the telemarketer claimed affiliation with consumers' credit card companies, the extent of its services consisted of a single call to the creditor asking for an interest rate reduction, which was routinely denied. The Commission also alleged that the defendant did not honor its refund guarantee to consumers who did not experience the promised substantial savings.

The Commission also has brought actions against for-profit debt settlement companies, alleging that defendants falsely promised to reduce substantially credit card debt.[31] In those cases, defendants allegedly deceived consumers into paying hundreds or thousands of dollars in upfront fees by misrepresenting that they would obtain lump sum settlements of consumers' credit card debt. In fact, the Commission alleged that defendants kept the upfront fees and had little if any success in obtaining the promised settlements.

There are a number of features for consumers to look for when assessing the legitimacy of debt relief services being offered. The legitimate non-profit credit counseling agencies commonly provide free budget analysis for consumers seeking a manageable debt repayment plan. They do not charge substantial fees for services. After reviewing a consumer's financial condition, the these legitimate agencies explain the possible options for the consumer. If consumers have sufficient income, the agencies can negotiate a debt consolidation plan (known as a "debt management plan") directly with the creditors on behalf of the consumer. The consumer then pays the agency one monthly amount which the agency then disburses to the credi-

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[27] *FTC* v. *Debt-Set*, No. 07–558 (D. Colo. 2007); *FTC* v. *Select Personnel Mgmt., Inc.*, No. 07–0529 (N.D. Ill. 2007); *FTC* v. *Dennis Connelly*, No. 06–701 (C.D. Cal. 2006); *FTC* v. *Express Consolidation*, No. 06–61851 (S.D. Fla. 2006); *US* v. *Credit Found. of Am.*, No. 06–3654 (C.D. Cal. 2006); *FTC* v. *Debt Solutions, Inc.*, No. 06–0298 (W.D. Wash. 2006); *FTC* v. *Debt Mgmt. Found. Servs., Inc.*, No. 04–1674 (M.D. Fla. 2004); *FTC* v. *Integrated Credit Solutions, Inc.*, No. 06–00806 (M.D. Fla. 2006); *FTC* v. *National Consumer Council, Inc.*, No. 04–0474 (C.D. Cal. 2004); *FTC* v. *Better Budget Fin. Servs., Inc.*, No. 04–12326 (D. Mass. 2004); *FTC* v. *Innovative Sys. Tech., Inc., d/b/a Briggs & Baker*, No. 04–0728 (C.D. Cal. 2004); *FTC* v. *Jubilee Fin. Servs., Inc.*, No. 02–6468 (C.D. Cal. 2002).

[28] *FTC* v. *AmeriDebt, Inc.*, No. 03–3317 (D. Md. 2003).

[29] See *FTC* v. *AmeriDebt, Inc.*, No. 03–3317 (D. Md. Jan. 9, 2006) (Stipulated Final Judgment and Permanent Injunction as to DebtWorks, Inc. and Andris Pukke). Subsequently, the court-appointed receiver determined that primary defendant Andris Pukke had hidden assets from the FTC, and the court entered a judgment requiring him to turn over tens of millions of dollars' worth of additional assets. Because he resisted turning over his assets even after the court found him in contempt of court, the Court ordered his incarceration pending full cooperation, lasting almost a month.

[30] *FTC* v. *Select Personnel Mgmt., Inc.*, No. 07–0529 (N.D. Ill. 2007) (litigation ongoing).

[31] E.g., *FTC* v. *Debt-Set*, No. 07–558 (D. Colo. 2007).

tors. The Commission's education and outreach program in this area includes a number of publications to help consumers who are seeking debt relief services.[32]

REAL ESTATE MARKETS

Question. Can you discuss for the record any inquiries the FTC has made into "infomercial" type marketing of "get rich easy" real estate investment schemes? Have you looked at the role those programs may have played in encouraging irresponsible speculation in the real estate market, including flipping activities that went bad? Or the degree to which those programs included suggestions that participants engage in occupancy fraud that led to a high degree of early payment defaults?

Answer. The Commission's testimony emphasized recent law enforcement and outreach efforts to tackle deceptive and unfair practices involving mortgage lending and servicing, and to halt mortgage foreclosure rescue scams, which impact the real estate market. As a general matter, we know that scam artists seize upon "hot" areas, such as real estate investment, to promote fraudulent business opportunities as "get rich quick" schemes. Such scammers promote their false promises of wealth through any medium, including infomercials.

The Commission has aggressively targeted the broad range of business opportunity frauds. In December 2006, the agency spearheaded "Project FAL$E HOPE$," which was a coordinated civil and criminal crackdown by federal and state law enforcers targeting more than 100 bogus business opportunities.[33] As part of that sweep, the FTC announced partial settlements in the Commission's pending case against a group of defendants that the FTC alleged telemarketed a product that purportedly instructed consumers on how to make easy money buying and selling privately held mortgages. In 2007, the Court issued summary judgment in the case by against the remaining defendants ordering them to pay $17 million in consumer redress.[34] The agency is generally aware that some real estate investment schemes have been promoted through infomercials, but it is not aware of any clear connection between such investment schemes and irresponsible speculation or occupancy fraud in the marketplace.

The FTC will continue to challenge false "get rich quick" claims that promote bogus investment opportunities, including those involving real estate, and will continue to combat deceptive and unfair practices that impact the real estate market.

CONCLUSION OF HEARINGS

Senator DURBIN. If there are no further questions, the subcommittee stands recessed.

[Whereupon, at 4:30 p.m., Wednesday, May 14, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

[32] Consumer education materials on debt relief and credit counseling issues are directly accessible from the FTC's webpage, Credit and Loans: In Debt?, available at www.ftc.gov/bcp/menus/consumer/credit/debt.shtm. In Spanish, the materials are available from the FTC's webpage, Crédito y Préstamos: ¿Endeudado?, available at www.ftc.gov/bcp/menus/consumer/credit/debt_es.shtm.

[33] http://www.ftc.gov/opa/2006/12/falsehopes.shtm.

[34] http://www.ftc.gov/opa/2007/05/stefanchik.shtm.

Material Submitted Subsequent to the Hearings

[The following agencies were unable to testify and have submitted statements for inclusion in the record.]

OFFICE OF PERSONNEL MANAGEMENT

PREPARED STATEMENT OF THE HONORABLE LINDA M. SPRINGER, DIRECTOR

Mr. Chairman and members of the subcommittee: I appreciate the opportunity to submit for the record a statement addressing the appropriations request for the Office of Personnel Management (OPM) for fiscal year 2009.

As you know, OPM provides a variety of products and services to the nearly 1.8 million employees in the Federal Government. Some of our products and services include managing health insurance for approximately 8 million current and former Federal employees and their families, administering retirement services for over 2 million retirees from all branches of Government, completing 90 percent of background investigations for industry and Federal agencies, and administering career development programs. As the OPM Director, I am committed to successfully delivering on our responsibilities on a timely basis. In short, I believe the American citizens and the Federal civilian workforce expect us to get things done, and our fiscal year 2009 budget request will allow us to do just that.

We are requesting $20 billion to carry out our mission in fiscal year 2009. Of this total, $19.8 billion is requested for mandatory programs and $228.9 million for discretionary activities. The discretionary request reflects $211 million for Salaries and Expenses—including transfers from the Trust Fund Accounts of $118.1 million—and $18 million for the Office of the Inspector General. The total discretionary request reflects a net decrease of $15.4 million compared to the fiscal year 2008 enacted level. I also want to note that OPM operates a revolving fund for the administration and operations of a number of programs including our Federal investigative services and Government-wide training efforts.

RETIREMENT CLAIMS PROCESSING AND BENEFITS PROGRAMS

OPM's request includes funding to improve the services it delivers to Federal employees, annuitants, and their families through the retirement and insurance programs.

On February 25, 2008, OPM began the rollout of the first ever Federal electronic retirement system. The budget requests an additional $15.2 million in No-Year Trust funds for continuation of this project. These funds will allow OPM to continue the conversion of millions of paper retirement records to electronic data and contract for the information technology needed for the system so that retirees can receive full payments once they separate from service eliminating interim payments at reduced amounts. At full rollout, employees will be able to model their retirement and initiate the process.

FEDERAL EMPLOYEES HEALTH BENEFITS PROGRAM (FEHB)

As the administrator of the FEHBP, OPM will continue to negotiate and contract with private insurance companies that offer a broad range of health insurance benefits, including high-deductible health plans with Health Savings Accounts and consumer-driven health plan options. As such, OPM will spend $26 million in fiscal year 2009 to ensure the viability of the Program's 283 health care plans covering over 8 million people. As usual, OPM will continue to carry out tough negotiations with health carriers to contain premium hikes. Over the years these negotiations have resulted in employee premiums that are substantially lower than those of the private sector while maintaining benefit levels, and continuing to provide, improve, and expand tools so customers can make informed health insurance decisions. In fact, the FEHBP increase for 2008 was 2.1 percent, compared to an average 8.7 per-

cent increase for the private sector and a 6.3 percent increase for the California Public Employees' Retirement System during that same year.

HUMAN RESOURCES MANAGEMENT

In fiscal year 2009, OPM will pursue policy initiatives that continue to reform human resources management in Federal agencies. We will work with the Department of Defense to ensure the reforms underway link pay to performance in a fair and consistent manner. At the same time, OPM will work with other agencies engaged in implementing Alternative Personnel Systems to assess the lessons learned from various modernization efforts. Mr. Chairman, in the last half-century, the Federal workforce has changed significantly, and the old personnel system has not kept pace. We are, therefore, striving to modernize the systems designed to recruit and retain federal employees.

The fiscal year 2009 budget will allow OPM to maintain the competitiveness of Federal employee compensation and benefits by exploring ways to refine market adjustments to Federal pay, and providing Federal employees with opportunities, benefits, and service delivery that compare favorably with other employers. For instance, OPM will continue to develop new workforce recruitment strategies and tools, and further improve the hiring process by developing a life-cycle reform model for agencies to adopt to streamline the current recruitment process. And last but not least, OPM will spend $200,000 to continue to support the Nation's returning Veterans by providing assistance in finding job opportunities with the Federal Government.

IMPLEMENTING HUMAN CAPITAL STANDARDS FOR SUCCESS

OPM will use requested funds to engage Federal agencies in implementing the Human Capital Assessment and Accountability Framework, and other best practices in human capital management, in keeping with the Merit System Principles, veterans' preference, and other standards. At the beginning of fiscal year 2008, 17 of the 26 agencies reporting under the President's Management Agenda Scorecard have met these standards, up from 11 in 2006, eight in 2005, and zero in 2003. As a result, more than 99 percent of the Federal civilian workforce is employed by agencies that have made significant progress toward meeting these standards.

Through its Compliance Program, OPM will continue to evaluate, review, and ensure agencies comply with Merit System Principles and veterans' preference, and to ensure whistleblower protection and other rights and privileges are honored and protected. OPM will strengthen this program through a human capital accountability system that holds agencies accountable for adhering to these principles, laws, and rules, as well as the human capital best practices referenced above.

HUMAN RESOURCES LINE OF BUSINESS

In 2009, OPM will continue to be a leader in the President's Management Initiative for Expanded Electronic Government and has included $7,202,000 in its request for this purpose. The requested resources will support the Human Resources Line of Business (HR LOB) and Enterprise Human Resources Integration (EHRI). HR LOB will continue to identify and document common functional, technical, and data requirements consistent with Federal human resources policies and will work toward the establishment of Federal and private sector Shared Service Centers to meet these requirements. During 2009, the EHRI project will continue to modernize how the Federal Government maintains, stores, protects, and transmits information on human resources transactions.

SECURITY-RELATED ACTIVITIES

The fiscal year 2009 request includes funding for a number of important security-related activities. OPM will implement Homeland Security Presidential Directive 12 (HSPD–12), Policy for a Common Identification Standard for Federal Employees and Contractors, which was signed by the President on August 27, 2004. This mandates the circulation of a Federal standard for a secure and reliable form of identification for Federal employees and contractors. HSPD–12 requirements will enhance OPM's strategic goal of improving security and emergency planning actions throughout the agency.

REVOLVING FUND

OPM also provides a variety of ongoing services that are financed by other agencies through our revolving fund. These services include providing one-stop access to high-quality e-Training products and services; offering professional development and

continuous learning for Federal managers and executives; providing employment information and assessment services; automating other agencies' staffing systems; providing examining services when requested by an agency; providing technical assistance and consulting services on all facets of Human Resources management; testing potential military personnel for the Department of Defense where it is cost-effective for OPM to do so; managing the selection, coordination, and development of Presidential Management Fellows; and conducting investigations for employees to determine whether they are suitable for employment, as well as more in-depth investigations for employees whose positions require security clearances. For those ongoing revolving fund responsibilities, the fiscal year 2009 budget includes an estimated $1 billion in obligations and 3,131 FTE to be financed through payments for OPM's services by other agencies.

MANDATORY PAYMENT ACCOUNTS

The OPM budget request also includes mandatory appropriations to fund the Government contributions to the health benefits and life insurance programs for Federal annuitants.

For the approximately 1.9 million annuitants participating in the Federal Employees Health Benefits Program, we estimate that about $9.6 billion will be needed to pay the Government's share of the cost of coverage. That represents an increase of $769 million over fiscal year 2008. We estimate that, for the 500,000 annuitants under age 65 who elect post-employment life insurance coverage, an appropriation of $46 million will be required.

Also, as mandated by the financing system established in 1969 by Public Law 91–93, liabilities resulting from changes (principally pay raises) since that year that affect retirement benefits must be amortized over a 30-year period. For that purpose, we are requesting a "such sums as may be necessary" payment to the Civil Service Retirement and Disability Fund in the amount of $10.2 billion. This represents an increase of $100 million to cover the service cost of the Civil Service Retirement System, which is not funded by and for active employees.

Thank you again for the opportunity to provide for the record a discussion of OPM's budget request for fiscal year 2009. I would be pleased to provide any additional information the subcommittee may need.

PREPARED STATEMENT OF THE HONORABLE PATRICK E. MCFARLAND, INSPECTOR GENERAL

Mr. Chairman and members of the subcommittee: Thank you for providing me this opportunity to discuss the President's fiscal year 2009 request for appropriations for the Office of the Inspector General at the Office of Personnel Management (OPM). The total request for the Office of the Inspector General is $18,000,000, which is $600,000 below the amount enacted for fiscal year 2008. Of our requested amount, $1,538,000 is from the salaries and expenses/general fund and $16,462,000 is from the trust funds. These resources are requested to perform our core functions which include:

—Conducting audits, investigations, and evaluations of agency programs and operations, including primarily carriers participating in the Federal Employees Health Benefits Program (FEHBP), the associated information systems, and internal agency operations and financial systems; and

—Issuing administrative sanctions, including debarments and suspensions to health care providers who pose a financial risk to the FEHBP itself or a health care risk to persons who receive health insurance coverage through the FEHBP.

The Office of the Inspector General recognizes that oversight of the retirement, health benefits, and life insurance trust funds administered by OPM is, and will remain, its most significant challenge. These trust funds are among the largest held by the United States Government. Their assets totaled $789.3 billion in fiscal year 2007, their receipts were $97.1 billion, and their annual outlays were $153.7 billion. The amounts of their balances are material to the integrity of the Government's financial position. I continue to allocate the vast majority of the Office of the Inspector General's efforts and resources to trust fund oversight, and we remain fully committed to trust fund activities.

OPM makes outlays from the retirement trust funds in the form of payments to millions of Federal annuity recipients. The health insurance trust fund provides payments to approximately 270 health insurance plans nationwide. In turn, the health insurance carriers pay millions of claims for services filed by their enrollees and health care providers. We have shown through our audits and investigations

that such health insurance payments may be at risk through improper, inaccurate or fraudulent claims.

We are obligated to Federal employees and annuitants to protect the integrity of their earned benefits. Our audit and criminal investigative work reduces losses due to fraud and improper payments and recovers misspent funds whenever possible. We have a special obligation to the Federal agencies and the American taxpayers, who provide the majority of the funding. We also seek to deter future occurrences of fraud and abuse within OPM programs, as well as serve to protect the health and welfare of beneficiaries of OPM programs and services.

Audits and criminal investigations of the OPM-administered trust fund programs have resulted in significant financial recoveries to the trust funds and commitments by program management to recover additional amounts. From fiscal year 2005 to the present, our office has cumulative judicial recoveries and audit recommendations to recover funds exceeding $440 million.

Beginning in 2005, the Office of the Inspector General established a nationwide field structure. As of 2008, the office has eighteen investigative and two audit field offices in addition to its headquarters in Washington, DC. We have determined that the most effective deployment of investigative staff is to locate them in areas of the country where FEHBP and retirement benefits are more concentrated. Experience has shown that criminal investigators located in these areas often work in cooperation with other law enforcement entities similarly located, resulting in additional criminal leads and better protection of OPM programs. In many instances, criminal investigators located outside of Washington, DC work exclusively on cases referred to them by local authorities. During fiscal year 2007, investigative work resulted in 46 arrests, 66 indictments, and 50 convictions.

During fiscal year 2009, we will continue to conduct audits of pharmacy benefit managers (PBMs), firms contracted by FEHBP carriers to administer their prescription drug programs. The premiums paid for prescription drug coverage have risen exponentially over the last ten years and allegations against PBMs have also increased. It is estimated that approximately $9.2 billion was paid during 2007 in prescription drug premiums to experience-rated and health maintenance organization (HMO) carriers. This represents approximately 28 percent of experience-rated and HMO carrier premiums paid for health benefits coverage for Federal employees and annuitants. In fiscal year 2007, we settled a large civil health care fraud claims case against an FEHBP PBM, resulting in $97 million returned to the OPM trust fund. We remain steadfast in our efforts to audit and investigate pharmacy benefits and pharmaceutical fraud within the FEHBP.

Also during fiscal year 2009, we will further our development of a data warehouse of health benefits claims. The data warehouse offers the best opportunity for global detection of erroneous health benefit payment transactions by medical providers, insurance carriers and subscribers by accumulating all benefit claims for all fee-for-service insurance carriers in a single data repository. This effort will enhance our current claims reviews by enabling the auditors and investigators to target certain types of potential claim payment errors on a program-wide rather than on a plan-by-plan basis. This will provide a significant improvement in our audit efficiency and effectiveness by offering us the opportunity to address significant issues of broad concern on a coordinated basis and to recover overcharges to the program when appropriate.

Currently in the data warehouse, we have data for the top three experience-rated carriers (Blue Cross Blue Shield, Mail Handlers Benefit Plan, and Government Employees Health Association), representing 86 percent of experience-rated plans claims payments. We are also receiving data from HMO plans with over 500 subscribers. This includes 85 plans, representing 87 percent of the HMO plans claims payments. The data is being accumulated and used for basic analysis to support premium rate calculations. Starting in fiscal year 2009, we plan to introduce more advanced claims analyses which recognize potential high risk areas for community-rated carriers.

Our administrative sanctions program has continued to improve its effectiveness in protecting the FEHBP and its enrollees against untrustworthy health care providers. This program enforces the FEHBP sanctions statute, which authorizes suspension or debarment of providers on the basis of 18 different categories of violations. The most frequently-encountered violations represent criminal convictions or loss of professional licensure. The highest priority sanctions cases involve providers who are the subject of investigation by our Office of Investigations. We select cases for action on the basis of the seriousness of the provider's violations and the risks that the provider poses to the FEHBP and to the health and safety of its subscribers. We currently have over 30,396 active debarments and suspensions in ef-

fect. We recently completed the conversion and digitizing of our debarment and suspension paper files and records to an electronic, searchable database.

Thank you for this opportunity to present our office's resource request for fiscal year 2009.

SELECTIVE SERVICE SYSTEM

PREPARED STATEMENT OF THE HONORABLE WILLIAM A. CHATFIELD, DIRECTOR

FORWARD

Chairman Durbin and members of this subcommittee, I am honored as Selective Service Director to present the President's fiscal year 2009 appropriations request of $22,000,000 for the agency. The Congress and administrations under both parties have acknowledged the wisdom of maintaining Selective Service as a hedge against unforeseen threats and as a low-cost insurance policy against underestimating any threat our Armed Forces might face in a still-dangerous world.

This agency is as determined as ever to make the necessary adjustments to budget realities and the requirements of combating terrorism, defending the homeland, and maintaining other priorities listed in the President's January 28, 2008, State of the Union Address. Personnel reductions at Selective Service have resulted from planned attrition and will not involve a reduction-in-force. Meanwhile, the agency continues its phased reductions in operational readiness while preserving as much customer service as possible. For example, we are reducing the number of part-time Reserve Component officers from a total of 250 to 200 by the end of fiscal year 2008 and to 150 by the end of 2009. Automated registrations are making it possible to accomplish our missions without the need for as much face-to-face contact at the local level. These innovations have required painful choices, but satisfying our goals will assure a Selective Service that is beyond reproach, while meeting the needs of its primary customer, the Department of Defense. I welcome the challenge and appreciate the opportunity to share my vision for Selective Service with you today.

WHAT WE DO TODAY

Selective Service is in business to perform two unique functions. Should the Congress and the President authorize a return to military conscription, the agency can conduct a draft that is efficient, fair, and accepted by the public. It is also ready to administer a program of alternative community service for men who are classified as conscientiously opposed to military service.

Additionally, each and every day Selective Service continues its close partnership with the Department of Defense by providing direct support to Armed Forces recruiting. Specifically, Selective Service provides names of registrants to the Secretary of Defense for recruiting purposes, in accordance with the Military Selective Service Act. Information about Armed Forces opportunities for Active Duty, National Guard, and Reserves, along with a business reply card, is enclosed routinely with our registration acknowledgment that Selective Service sends to each new registrant. For fiscal year 2007, these contacts totaled nearly 2.2 million young men. Consequently, the Defense Department benefits by "piggy-backing" on our routine mailings which generate actual recruiting leads. And it reimburses us for the additional costs in accordance with the Economy Act.

Beyond its compliance with the Military Selective Service Act and providing these tangible services, the agency also promotes an intangible national benefit. For present and future generations of America's young men, Selective Service is a very critical link between society-at-large and today's volunteer military. It is a reminder that, as Americans, every young man is personally responsible to "provide for the common defence" in the time-honored tradition of preceding generations.

AREAS OF EMPHASIS

Air Shows.—I look forward once again in 2008 and continuing in 2009 what I regard as this agency's most creative innovation in meeting its traditional mission in a climate of budget austerity. I refer to our success in harnessing the venue, excitement, and patriotism of air shows.

My vision has been to present the agency in huge, open community venues across the Nation, highlighting authentic American heroes and promoting public service and patriotic themes appealing to multiple generations. The value of this effort presented itself after my assessment of the agency's capabilities, priorities, and missions. Air shows are the second most attended spectator events in America, attracting a high concentration of registration-age men. I remain convinced that funding

this initiative results in a substantial increase in registration compliance and represents a positive impact on the influencers of young men. We are conducting this effort by absorbing the $118,000 expense out of our fiscal year 2008 budget and will do so again in fiscal year 2009. No new money is involved.

Registration Compliance.—As exciting as the air show initiative has been, it will not be the only effort to satisfy our statutory missions. Our operational readiness to perform our traditional missions has been reduced because of world risk assessments. Selective Service has always believed only when all eligible young men are in the manpower pool and accounted for as equally vulnerable would any future draft be considered completely fair and equitable by the public.

Our latest full year of data collection (CY 2007) indicates 91 percent of legally eligible men (ages 18 to 25) are registered; this is a 2 percentage point drop from the previous year. The compliance rate for men who are draft eligible (ages 20 to 25) is 95 percent, a 1 percentage point decrease from CY 2006. Keeping the rates high is very important because a declining compliance rate contributes to a lack of public confidence in our ability to administer a fair and equitable draft.

Naturally, this agency is as determined as ever to make congressional priorities truly our own. We appreciate the subcommittee's support for ensuring that our work continues. To the extent that our traditional mission survives, I will use every resource to continue to maintain high registration compliance. For example, the agency will:

Carry on routine updating of the interactive Selective Service pages on the World Wide Web (www.sss.gov) where online registration, registration verification, the ability to file changes of information, and a wealth of other agency information are available to anyone with access to the Internet. For fiscal year 2007, 83 percent of registrations reached Selective Service through electronic means, the same percentage as 2006. Electronic registrations are encouraged because they are quicker, more cost-effective than processing paper registrations, and provide better customer service. We are also placing links to our site with other Federal, State, and local agencies, schools, and assorted organizations to enhance public education and facilitate customer responsiveness.

Profit from an increasing number of States that link obtaining a driver's license or State identification card to the Selective Service registration requirement. These State and territorial laws currently provide Selective Service with an average of 71,000 registrations per month. As of this month, 36 States, 3 territories, and the District of Columbia have enacted laws. These jurisdictions represent 70.1 percent of the national 18-year-old male registrant population. We continue to offer technical expertise to the other States where such legislation is pending. Data electronic exchanges are the most cost-effective, timely, and user-friendly registrations available. Selective Service is committed to aid the remaining 14 States in implementing this easy method to protect their young men's eligibility for State and Federal benefits and programs. This program has been a valuable tool to reach all eligible registrants and is more customer-friendly.

Remain sensitive to the fact that not every household in your district has a computer, so technological innovations will not compensate for all resource restraints. The only way for young men in those households to register is the old-fashioned, pre-Internet way. That means going to the nearest post office. And that is why we must devote sufficient resources to printing forms and keeping post offices well stocked.

Alternative Service Program.—Half of the agency's mission during any return to conscription is to provide for a supervised term of alternative civilian service for all men it classifies as conscientious objectors. A key component of this program, therefore, is reaching out to employers capable of providing work of "national importance" by becoming members of the Alternative Service Employer Network, or ASEN. We continue to reach out to historic peace church constituencies, non-profit organizations, and Government entities. These have, in past wars, provided the bulk of the assignments we will need to provide our alternative service workers with employment that benefits the national health, safety, and welfare.

We have had negotiations with Christian Aid Ministries, Mennonite Voluntary Services, and others who hope to join the ASEN. We also continue to have our State Directors visit the projects run by these organizations to determine their suitability to become ASEN members. In addition to visiting model project sites, our State Directors have begun to reach out to our historic conscientious objector constituencies across America. These contacts and outreach efforts were previously confined to our headquarters staff. In addition to making it easier and less expensive for the public to stay in touch with us, this field effort facilitates the building of the relationships we will need to successfully meet our goals for this program during any return to conscription.

Finally, we continue to work toward obtaining employer agreements with the Public Health Service and the Corporation for Community and National Service. These two Federal entities will, we hope, play a key role in providing suitable employment to conscientious objectors in any future conscription.

Information Technology Modernization.—The agency's Reclassify, Compliance, and Verification project is intended to allow Selective Service System to leave the Department of Defense's Military Entrance Processing Command mainframe and move to a Microsoft Windows system. However, it is behind schedule. Selective Service hopes to complete the analysis, scope, and requirements definition during fiscal year 2008, and we plan to design, code, and test in fiscal year 2009. Notwithstanding resources expended so far, if our revised schedule is not met, then the entire project will be shelved pending future resources and commitment.

NATIONAL IN SCOPE, LOCAL IN SERVICE

While rumors of a future draft will continue to circulate among the public, private groups, the media, and academia, Selective Service remains focused on missions mandated by Congress. It manages its volunteer board members; prepares to administer a program of alternative community-based service for men classified as conscientious objectors; and, to the extent possible, updates its conscription plans and registration procedures. All these efforts are aimed at being ready to conduct a fair and equitable classification procedure to determine who should serve when not all can serve during an emergency. To ensure fairness and equity, each Selective Service board is a gathering of civic-minded men and women reflecting the racial, cultural and ethnic diversity of the young men in your districts. Through these volunteers, a unique bond has been formed at the grass roots with young American men, society-at-large, and the U.S. Armed Forces. Through the Selective Service structure, local American communities play a positive role in providing for the common defense.

CLOSING

Mr. Chairman, Selective Service stands prepared to perform its time-tested responsibilities when directed. The fiscal year 2009 appropriation request of $22,000,000 will be invested prudently in one of the Nation's important security assets in an increasingly dangerous and ambiguous world. Maintaining this adequate funding level would: (1) provide a compact, cost-efficient civilian structure capable of expansion in a crisis; (2) provide manpower to the U.S. Armed Forces as required; and (3) do it fairly, equitably, and within the necessary timeframes. These outcomes will advance our statutory mandate and restore the high registration compliance rates so painstakingly achieved over the last decade. Selective Service remains an active partner in the national preparedness community, ever watchful for opportunities to improve.

Thank you, Mr. Chairman. I would be pleased to answer your questions.

COURT SERVICES AND OFFENDER SUPERVISION AGENCY FOR THE DISTRICT OF COLUMBIA

PREPARED STATEMENT OF PAUL A. QUANDER, JR., DIRECTOR

The Court Services and Offender Supervision Agency (CSOSA) supervises approximately 15,000 men and women offenders on probation, parole, or supervised release in the District of Columbia at any given time. CSOSA includes the D.C. Pretrial Services Agency, which supervises another 5,000 defendants at any given time to ensure that they comply with court-imposed release conditions and appear for scheduled court dates. These agencies make a vital contribution to public safety in Washington, D.C.

This statement is provided in support of CSOSA's fiscal year 2009 budget request of $202,490,000 including 1,297 permanent positions and 1,293 full time equivalents (FTE). Of this amount, $54,838,000 is requested for the Pretrial Services Agency (PSA) and $147,652,000 is requested for the Community Supervision Program (CSP). The fiscal year 2009 request for CSOSA represents a $12,147,000, or 6 percent, increase over fiscal year 2008 enacted levels.

BACKGROUND

Since CSOSA was created under the National Capital Revitalization and Self-Government Improvement Act of 1997, we have implemented significant program enhancements, particularly in post-release supervision. Probation and parole caseloads

have been lowered dramatically—in many cases by 50 percent—to meet or exceed the recommended national standard of 50 cases per Community Supervision Officer (CSO). Since fiscal year 1999, monthly surveillance drug testing has increased 360 percent; last year, over 8,300 offenders were tested each month. CSOSA operates six field offices to locate CSOs in the neighborhoods were offenders live and work, and over 8,000 joint field visits by CSOs and the Metropolitan Police Department occurred in those neighborhoods last year. Since fiscal year 2004, CSOSA has placed over 2,000 high-risk offenders on Global Positioning System (GPS) monitoring to reinforce compliance and track their location; the Metropolitan Police Department routinely uses GPS data in crime investigation.

CSOSA has also received resources for contract substance abuse treatment to supplement the District's public treatment system. Last year, we made over 2,400 offender and over 1,600 pretrial defendant placements in our continuum of services, which includes detox, residential, transitional housing, and outpatient services. We also continue to implement the Reentry and Sanctions Center, a residential program that provides intensive assessment and treatment readiness services for high-risk offenders and defendants. Since the facility's opening in 2006, we have placed 1,188 individuals in the program; 88 percent have completed it successfully.

CSOSA recognizes that successful supervision involves both managing risk through close supervision and addressing need through the provision of treatment and support services. We have implemented many enhancements to ensure effective risk management. We work closely with a variety of Government, non-profit, and faith-based partners to increase offenders' access to existing services and build additional capacity in the core need areas of housing, education/training, and health care. Through the Criminal Justice Coordinating Council's Reentry Steering Committee, we provide leadership of efforts to address the needs of supervised offenders, particularly those returning to the District from incarceration.

One of our most significant accomplishments of the past year has been the implementation of a new performance management system (SMARTStat) that tracks a core set of supervision practices down to the individual case level. Through this system, we can determine the extent to which cases are being managed effectively. This information is available to supervisors and branch chiefs, who are encouraged to use it as part of their case audits and team meetings. The information forms the basis of regular reviews with the entire CSP executive staff, during which action items are assigned and outcomes regularly tracked so that problems can be solved quickly.

2009 BUDGET INITIATIVES

CSOSA's fiscal year 2009 budget contains two initiatives, one for CSP, which provides information technology resources for post-release supervision, and one for PSA, which provides resources for supervision of D.C. Misdemeanor and Traffic Court (drunk driving) cases.

CSP Information Technology Enhancement Initiative

CSP requests $2,583,000 and ten (10) positions to continue building its information technology infrastructure, including enhancements to the Supervision Management Automated Records Tracking (SMART) case management system.

Improving the quality, management, and utility of information has been a CSP priority since CSOSA's founding. CSP inherited outdated, cumbersome legacy systems from its predecessor agencies. In 1997, most probation and parole officers relied on paper case files and lacked access to personal computers. Developing an automated case management system and training staff to use it were essential to successful implementation of the agency's program strategy. CSP launched the initial version of SMART in 2002, following a remarkably efficient requirements gathering and application development process.

SMART is now in its third release. From its initial core supervision tracking functions, the system has expanded to encompass modules that capture treatment placement and expenditures, the development of Alleged Violation Reports, vocational and education assessment, and other critical program functions. We are also developing an Enterprise Data Warehouse (EDW) as a repository for historical data that can be used for research and performance measurement. The EDW is the source of CSP's new performance management system, SMARTStat, which provides management and staff with complete visibility into offender supervision practices and effectiveness. CSP also developed and maintains the District's Sex Offender Registry (SOR).

CSP's Office of Information Technology (OIT) develops and maintains the CSP infrastructure, including acquisition, support, maintenance, and life-cycle replacement of architecture/design/systems enhancements, the EDW, IT security services, disaster recovery, and operational services, such as customer support (Help Desk), net-

work management, change and configuration management, e-mail, and system administration services.

The requested resources will continue the significant progress made by CSP OIT to increase the timeliness and accuracy of data used by agency staff and our partners to make day-to-day law enforcement decisions affecting public safety in the District. These resources will be used to continue SMART and SOR enhancements, transition to a next-generation Service Oriented Architecture platform, continue building the EDW and performance management platform, and continue improving our capacity to integrate data with our partner agencies.

The resources will be allocated as follows:

Infrastructure Enhancements

—$300,000 in contract funding to support EDW software, development and maintenance;

—Five (5) New Positions: Two Systems Engineers (GS–13); One infrastructure Architect/Project Manager (GS–14); One Customer Support Specialist (GS–8); One EDW Database Administrator (GS–13).

SMART Enhancements

—$1,000,000 in contract funding to support SMART, SOR and Data Sharing development and maintenance;

—Five (5) New Positions: One Systems Integration Architect (GS–14); One Systems Integration Analyst (GS–13); One Configuration Manager (GS–13); One Business Intelligence Analyst (GS–13); and One Technical Writer (GS–13).

CSP OIT currently lacks sufficient staff to sustain operations and to plan and implement migration to an "agile" service-based infrastructure. Current CSP funding does not provide sufficient ongoing resources to maintain the current IT infrastructure and continue the SMART development process. To date, CSP has been able to support the significant SMART and IT infrastructure accomplishments through delayed operational costs at two new field units. One of those field units (Rhode Island Avenue) became operational in fiscal year 2006, and the other is planned for implementation in fiscal year 2009. Without the requested fiscal year 2009 resources, planned SMART, partnership/data sharing and infrastructure improvements will be significantly reduced, affecting the effectiveness and efficiency of CSP and our law enforcement partners.

Lack of additional resources will effectively derail investments made in our information technology (IT) infrastructure over the past 2 years, most of which were implemented to comply with Federal IT mandates for security, disaster recovery and performance management. It is vital that CSOSA have the IT capability to effectively perform its law enforcement and public safety functions for the Nation's capital. Compared to its Federal counterparts, CSOSA is still very new and very small. We are still in need of funding for critical IT infrastructure and developmental initiatives to implement the full scope of the local public safety functions that CSOSA was created to assume.

PSA Misdemeanor and Traffic Court Supervision Initiative

In our other new budget initiative, PSA requests $3,340,000 and 23 positions for defendant supervision, substance abuse and mental health assessments, and drug testing services for D.C. Misdemeanor and Traffic Court (drunk driving) cases.

In 2006, the Office of the Attorney General's (OAG) Criminal Section papered over 12,400 D.C. misdemeanor and traffic cases. Based on estimates from the OAG's Public Safety Division and the D.C. Superior Court, over 3,600 of these cases (29 percent) involved defendants in need of mental health and/or substance abuse treatment services. To better address the problems and community safety issues within this population, beginning in fiscal year 2009, the D.C. Superior Court and OAG will lead a court-centered, problem-solving initiative geared to the unique problems and service requirements of mentally ill and substance abusing arrestees. This initiative will identify mental health and substance abuse issues in this population and link defendants to community-based services; ensure the least restrictive diversion and community supervision options needed to address public safety and treatment concerns; ensure comprehensive and individualized treatment and supervision placements; provide a comprehensive team-oriented approach to addressing health and social issues geared to a defendant's criminal behavior; and provide supervision of participants, including court notice for infractions of supervision conditions.

The initiative already has the support of many local criminal justice and community partners. Defendants will be referred to the District of Columbia's Addiction Prevention and Recovery Administration (APRA) and the Department of Mental Health (DMH) for needed treatment services. DMH also will establish a crisis care center within the D.C. Superior Court to temporarily assist defendants with severe

mental health issues. The city's Department of Employment Services (DOES) will offer job referral and training geared to the special needs of this population.

The missing elements of the program design are strong defendant supervision and drug testing, as well as assessments for and linkages to needed treatment and social services in the community. Therefore, the D.C. Superior Court and the OAG have requested that PSA provide supervision, substance abuse and mental health assessments, linkage to treatment, and drug testing services. Supervision would include conditions such as weekly drug testing, in-person contact as needed with a case manager, and referrals to treatment and social service agencies. Besides helping the OAG, the Court, and other collaborative partners meet an important strategic goal, this assistance would help PSA meet its statutory obligation under D.C. Code § 23–1303(h) to provide supervision to all defendants released with conditions and to address within this population what potentially may be unacceptable safety risk to the Washington metropolitan community.

To ensure proper management of treatment and other conditions, as well as prompt administrative and judicial responses to infractions, PSA recommends a maximum case manager-to-defendant ratio of 1:75.

The proposed request would fund the following supervision, drug testing, and treatment assessment personnel costs: 12 Pretrial Service Officers; 1 supervisory Pretrial Service Officer; 3 Community Treatment Specialists; 2 Chemists; 1 Laboratory Technician; 3 Drug Testing Technicians; 1 Program Assistant; and $120,000 for drug testing supplies (chemical reagents).

PSA data supports enhanced supervision for defendants charged with serious traffic offenses as well as misdemeanants with serious mental health and substance abuse needs. Drug-involved defendants are three times as likely to be rearrested and more than twice as likely to fail to appear as non-users. Introducing pretrial supervision to the high risk defendants in D.C. Misdemeanor and Traffic Court who have mental health and substance abuse challenges will assist the Court in enhancing public safety and assuring that these defendants keep their court dates.

This initiative will also enhance PSA's collaborations with the D.C. Superior Court, OAG, and other criminal justice and community partners. The proposed initiative is a combined effort to screen, assess, and supervise potentially high-risk defendants who now receive little or no supervision and support. No other partner in this initiative can provide the assessment, supervision, and drug testing of this population; these services are needed to ensure court appearance and protect the public.

Adjustments to Base

CSOSA also requests $6,224,000 in adjustments to base to fund employee cost of living pay raises and general price increases. Of this amount, $4,620,000 is for CSP, and $1,604,000 is for PSA.

CONCLUSION

CSOSA's budget initiatives reflect the developmental challenges the agency continues to face. While CSP has implemented a wide range of program enhancements, such progress necessitates ongoing maintenance and expansion of IT infrastructure to ensure that our ability to manage cases efficiently, analyze data, and measure performance keeps pace with our operations. PSA continues to face the need to collaborate with and support its partners—most particularly, Superior Court—by participating in initiatives that will enhance defendant compliance and protect the public.

Unless CSOSA responds to these challenges, we are at risk of losing the ground we have gained. These initiatives will enable us to continue building and supporting a model supervision system that achieves the benefits CSOSA was established to bring to the District of Columbia: increased public safety, reduced recidivism, and enhanced systemwide collaboration.

We appreciate the support we have received to date, and we look forward to working with the Committee on this request.

LIST OF WITNESSES, COMMUNICATIONS, AND PREPARED STATEMENTS

SUBJECT INDEX

FEDERAL TRADE COMMISSION

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